IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 15724

FRED C. NIEDERKROME, E. ROYCE, DORA F. ROYCE, EZRA ROYCE, B. ROYCE, ESTATE OF ISABELLE H. ROYCE, DECEASED, B. ROYCE, Executor, ROBERT T. JACOB, AGNES C. JACOB, ALBERT L. SCHNEIDER and BERTHA SCHNEIDER, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

On Petitions for Review of the Decisions of the Tax Court of the United States

REPLY BRIEF FOR PETITIONERS

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We respectfully submit that the respondent's brief fails to justify the decisions below. Indeed, his various contentions confirm our view that the Tax Court has gravely erred in sustaining the disputed deficiencies. We will now examine the respondent's arguments in order to focus on the precise differences between the parties.

I. Oregon Motor Stages

1. In so far as section 115(g) is concerned, the respondent's entire case rests precariously on an alleged conspiracy in tax avoidance. According to the respondent, "the taxpayers evolved a plan to acquire complete ownership of

Oregon Motor Stages, whose stock was worth $750,000, by using $350,000 of Stages' surplus as part payment. This was accomplished by setting up one Bentson as a straw man, an ostensible borrower of $350,000 from ABC and an ostensible stockholder in the corporation." (Resp. 36. See also *id.* 43, 48.) As the respondent seems to realize (Resp. 43, 48), this accusation necessarily presupposes that the five petitioners entered into an anticipatory plot to avoid income tax. For, obviously, there was no sense in resorting to Bentson as a "straw" except as a means of escaping the dividend tax on a quick redemption of the 350 shares. Unless the petitioners, well in advance, deliberately set out to divert an impending tax on a contemplated distribution, the deception with which they have been charged served no function whatever. Even the respondent has been unable to supply any other possible motive for the scheme which he has imputed to the petitioners via Bentson. By the same token, then, the respondent's argument completely breaks down. The record does not contain the least suggestion of intrigue or machination in tax avoidance. Nor did the Tax Court at all intimate that the petitioners were animated by any such motive. In short, in order to sustain substantial deficiencies the respondent has simply conceived some sort of elaborate plan which lacks any discernible purpose.

2. Quite apart from this alleged plot without purpose, the respondent's argument has little to commend it. The respondent concedes that there is evidence, given by all five petitioners, "that Bentson took an active part in the purchase of the stock and the negotiations for the loan from ABC." (Resp. 45.) However, the respondent then attempts to bypass the evidence. "That Mr. Bentson did not participate in the events leading up to the negotiation of the loan," he declares, "is apparent from the statements of the taxpayers to the revenue agents prior to the trial herein, from the records of ABC and from the fact that negotiations for the loan were made prior to the time Bentson even

arrived in Portland, thus making it physically impossible for him to have submitted the application for the loan, and/or to have participated in the negotiations." (Resp. 45-46.) In other words, the respondent relies essentially on three specific items as reasons for ignoring Bentson despite the positive, detailed testimony of the five petitioners. The three items are Bentson's alleged arrival after the loan was negotiated, the evidence of the revenue agents, and Exhibit A. Since we have fully examined the first item in our prior brief, it seems unnecessary to reappraise it. In holding that Bentson could not have participated in the negotiations, the Tax Court simply became entangled in an imaginary difficulty of its own making. (Pet. 38-39.) The respondent has noticeably made no effort to indicate otherwise. He has been content to repeat what the Tax Court erroneously surmised. (Resp. 47.) Therefore, we turn to the remaining two matters on which the respondent relies: the testimony of the revenue agents and Exhibit A.

3. Two agents testified on behalf of the respondent. They were Robert D. Amos and Donald D. Nicholson. (R. 577, 609.) Nicholson merely stated that his answers would be "substantially the same as Mr. Amos' answers." (R. 610.) Hence we need only consider the testimony of Amos. As persuasive proof that Bentson "did not take part in the negotiations leading up to the loan" (Resp. 37), the respondent refers to Amos' summaries of his conversations with E. Royce, Jacob, and Niederkrome during his investigation. (Resp. 45-47.) The respondent has managed to find in Amos' testimony far more than it reveals. At the same time he has been a good deal less than complete in quoting and paraphrasing Amos' evidence for the benefit of the Court. What has been omitted is not in accord with what has been inferred.

On the basis of Amos' testimony the respondent says, "E. Royce informed the revenue agents that the financial arrangements with respect to the ABC loan were handled

by Jacob and McColloch, the attorneys for the former stockholders." (Resp. 45.) "This statement," the respondent then observes, "is, of course, in marked variance with the testimony given by E. Royce during the trial herein." (Resp. 45, n. 4.) When Amos' testimony is read, the "marked variance" is nowhere to be found. What E. Royce stated to Amos he later stated in court. On direct examination Amos testified (R. 583-584):

> "A. On January 4th, 1949, Mr. Nicholson and I interviewed Ezra Royce at his office at the Yellow Cab Company regarding the stock transaction in Oregon Motor Stages.
>
> Q. What did he have to say? At that time?
>
> A. Well, he explained that Mr. Bentson obtained a loan from the American Business Credit Corporation. We asked him what collateral was put up. He said that he didn't remember who put up the collateral, and he referred us to Claude McColloch and Robert Jacob, who, he said, were the attorneys who handled the transaction.
>
> Q. Did he say anything about the arrangements for the loan? Did he say who, if anybody, had anything to do with that?
>
> A. I will have to refresh my memory. I am not sure.
>
> Q. Just go ahead and look at your notes—as much as you desire.
>
> A. All right. (Referring to notes.) Regarding the arrangements for the loan, he stated that Claude McColloch and Robert Jacob were the attorneys who handled the arrangements with the loan.
>
> Q. Would you tell us about his attitude in the interview?
>
> A. He was cooperative. He did not furnish us many details. He did refer us to Mr. Jacob for further information."

On cross-examination Amos produced the memoranda of his conversation with E. Royce, and further testified as follows (R. 603-604):

> "Q. Now, this was dictated the day after you had your conversation, wasn't it?

A. Well, it was typed by me the day after I had the conversation, and it was based on notes which I took at the time of the conversation.

Q. And in this, Mr. Royce informed you that Mr. Bentson had received the same price he had paid for the stock?

A. I am sure of that, yes, I would have to—yes.

* * * * * * * * *

Q. (By Mr. Jones): Did he also explain to you that Mr. Bentson's wife had got sick, and that the war was over, and Mr. Bentson wanted to get out?

A. Yes.

Q. He also told you at that time that Mr. Bentson had made eight or nine hundred thousand in Alaska mining?

A. May I see that? (Paper handed.) Yes, he did."

We fail to see how this testimony proves that Bentson was a "straw" for the petitioners. We also fail to see how this evidence in any way contradicts the testimony of E. Royce or impairs his credibility. E. Royce told Amos exactly what he stated at the trial—that Bentson obtained the loan from ABC-Portland; that Bentson paid for the stock; that Bentson received the distribution in redemption of the stock; and that Bentson decided to dispose of his stock after the war ended and his wife became ill. (Pet. 4-7, 43-44.) Although the respondent purports to give a fair summary of Amos' testimony, all this is omitted in the effort to find a "marked variance." The respondent seems to derive some comfort from E. Royce's statement that Jacob and McColloch "handled the arrangements with the loan." Needless to say, E. Royce was only indicating that the legal aspects of the loan were handled by the two attorneys who represented the buyers and sellers.

The respondent's next item of evidence through Amos is the latter's summary of his conversation with Jacob. To quote the respondent once more, Jacob told Amos "that his part in the loan negotiations was limited to introducing E. Royce and Bentson to George Davidson, manager of

ABC-Portland, and that the loan negotiations were carried on by them." (Resp. 45.) The respondent then admits that Jacob told "the same story" at the trial (Resp. 45)—and that story, of course, was that Bentson actively participated in the purchase of the stock and the negotiations for the loan. (Pet. 4-6, 33-34.) Again we are at a loss to understand how Amos' testimony enables the respondent to say that his view of the facts is supported by "the statements of the taxpayers to the revenue agents prior to the trial herein." (Resp. 45.) As Amos reported the conversation in question, Jacob "explained that Mr. Schneider and Ezra Royce had approached him, and asked him to go in with them in buying the stock. He said that he negotiated with the former stockholders, and he said that he had nothing to do with Mr. Bentson's purchase of stock. He said that he believed Mr. Royce made the arrangements for that. He said that he introduced Mr. Bentson and Mr. Royce to Mr. Davidson of American Business Credit Corporation, and Mr. Bentson then obtained a loan." At the time of the interview Jacob did not recall "what collateral was pledged." (R. 585.)

The respondent does not do better when he refers to Niederkrome's so-called "admission" to the revenue agents "that the taxpayers borrowed the $350,000 from ABC." (Resp. 46.) Here, too, the respondent is desperately foraging for some bit of evidence where none is available. And here, too, he has been markedly selective in summarizing the testimony of his own witness. He fails to mention what fails to sustain him. As in the case of the evidence concerning E. Royce's statements, we shall now supply what the respondent has omitted.

Amos testified that he met with Niederkrome more than five years after the purchase of the stock, and that Niederkrome "was just talking from memory" without the aid of any records. (R. 594, 606.) Niederkrome stated that "he had never heard any discussion regarding Mr.

Bentson's interest" and that "he knew Mr. Bentson acquired stock;" but he did not recall "why it happened, and he said, as far as he knew, Mr. Bentson may still own stock in the corporation." (R. 594.) Niederkrome did not recollect "whether stock was put up as collateral for the loan" by ABC-Portland, "but he did know that a loan was obtained and he explained the general financing of the transaction. He said that the new group of stockholders put up four hundred thousand dollars, and they borrowed three hundred fifty thousand dollars." (R. 594-595.)[1] Then Amos immediately corrected himself in his next sentence. We quote this sentence, which the respondent excluded from his brief: "He said he thought that the loan was obtained by the corporation, and he did not know how or when the loan was repaid." (R. 595.) On cross-examination Amos several times repeated that Niederkrome "said he thought" the loan was made to the corporation. (R. 606-607.) Niederkrome later testified that when he met with the revenue agents, he spoke solely from memory. He denied having stated that the loan was made to the corporation. "I think what I told them was that the payment was made by the Oregon Motor Stages." (R. 622.)

Four conclusions emerge from this testimony. First, after more than five years Niederkrome's remembrance of things past was understandably hazy — particularly since his recollection was not refreshed by any documents. Second, if Amos' testimony is correct, at most it indicates that Niederkrome at the time erroneously thought the loan had been made to the corporation. Third, the respondent is relying on one sentence in Amos' testimony, but it is the very sentence which Amos promptly

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[1] In paraphrasing these words—which Amos immediately abandoned—the respondent subtly alters them to say that Niederkrome admitted "that the taxpayers borrowed the $350,000 from ABC." (Resp. 46.) Amos referred to "the stockholders," not to "the taxpayers." At no time did Niederkrome tell Amos that Bentson was not one of the stockholders. Nor did Amos ever intimate that he did.

abandoned. Furthermore, in paraphrasing that discarded sentence, the respondent has revised it so that it harmonizes with his desired conclusion.[2] Fourth, the testimony does not at all suggest that Bentson was a "straw." Certainly Niederkrome's faulty recollection that the corporation borrowed the money — assuming that Amos' testimony was accurate — sheds no more light on Bentson than on any of the other participants. For that matter, Niederkrome specifically told Amos what the respondent significantly omits in his brief — that "Mr. Bentson acquired stock" in the corporation. (R. 594.)

We conclude that nothing in "the statements of the taxpayers to the revenue agents" impairs the testimony of the petitioners. Our appraisal is fully reinforced by the opinion below. Even the Tax Court did not consider "the statements" as any kind of evidence in support of the result which it reached. "The statements" of E. Royce and Jacob, which the respondent now considers so uniquely material, are not mentioned at all in its findings of fact or in its opinion. (R. 221-244.) And Niederkrome's alleged "statements" are referred to in the findings merely to indicate that, during his conference with the agents, he "thought the corporation had obtained the loan from ABC." (R. 232.) They do not enter into the Tax Court's later analysis of the legal issues. In any case, the Court did not understand Amos' testimony as the respondent would now read it in accordance with his substantial alteration and omissions.

4. Exhibit A is the third item on which the respondent heavily leans as potent proof that Bentson did not borrow the $350,000. See pp. 2-3, *supra*. We have argued that Exhibit A was pure inadmissible hearsay, and that in any event it had no probative weight alongside the ample testimony under oath and subject to cross-examination. (Pet. 45-57.) The respondent recognizes that Exhibit A

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[2] See note 1, *supra*.

was plainly inadmissible unless it duly qualified as a routine business entry under the Business Records Act. The exhibit failed to qualify for three basic reasons: (1) despite the petitioners' objections, the respondent did not provide the necessary foundation for its admission (Pet. 48-50); (2) aside from the lack of foundation, the exhibit was not inherently trustworthy (Pet. 50-53); and (3) apart from these inadequacies, the exhibit did not record any "transaction" within the scope of the statute or in controversy here. (Pet. 53-55.) In the light of our arguments the respondent makes several answers. The first is that the taxpayers "admitted the authenticity and identity of this document." (Resp. 52.) The second is that Exhibit A is trustworthy because "corporate minutes are entries made in the routine course of business." (Resp. 52-53.) Then the respondent moves off in a third direction. "In any event," he asserts, "assuming arguendo the correctness of all of the taxpayers' contentions in this respect, the admission of the exhibit was not prejudicial." (Resp. 53.)[3] We now consider these answers in the same order.

The respondent does not deny that he failed to lay a foundation for the admission of Exhibit A. Instead he contends that the argument directed to the lack of foundation "is aimed at a point which has been already conceded by taxpayers." (Resp. 52.) Again the respondent is not too attentive to the record. The stipulation of facts between the parties includes two special paragraphs which carefully distinguish between Exhibit A and all other exhibits referred to in the stipulation. (R. 213-214.) The first of these two paragraphs states, "All the exhibits herein mentioned, except Exhibit A, may be offered and received in evidence at the trial . . . without further

[3] The respondent states that the "main complaint about the exhibit appears to be that the Commissioner failed to lay a proper foundation for its reception." (Resp. 51.) Evidently the respondent has not entirely understood our position. The argument concerning the lack of foundation is not the "main complaint." It is one of several serious contentions.

identification or authentication; subject, however, to such objections as counsel makes thereto at the trial on the ground of competency, relevancy, or materiality. All said exhibits (except Exhibit A) shall be considered as having been offered and received in evidence in these cases unless objection is made thereto and the objection is sustained." (R. 213.) The second of the two paragraphs provides, "Exhibit A is not attached hereto. Said exhibit may be offered in evidence at the trial . . . without further identification or authentication, subject, however, to any and all other objections as counsel may make thereto at the trial . . . ." (R. 213-214.) Hence at the start of the hearing all the mentioned exhibits, other than Exhibit A, were deemed in evidence unless an objection was made and sustained. In sharp contrast, Exhibit A was not attached to the stipulation; it was not in evidence unless it was offered and received; and, if offered, it was subject to any and all objections, including incompetency. (R. 588.) Needless to say, a reservation of the right to object for incompetency embraces hearsay.

In accordance with the stipulation counsel for the respondent affirmatively moved that Exhibit A be admitted in evidence. In offering the exhibit he left no doubt that he expected the petitioners to object. "There is going to — the objection to this instrument will be given by Mr. Jones." (R. 611.) As a result, counsel for the respondent attempted to justify the admission of the exhibit as a record akin to the various records of ABC-Portland already in evidence. (R. 611-613.) Mr. Jones immediately objected "strenuously" to the admission of the exhibit on the ground, among others, that it was "purely hearsay." He expressly distinguished the other documents as involving "payments back and forward;" hence the petitioners "had no objection to and consequently were quite willing to assist the Government by admitting them and putting them to no trouble." Mr. Jones went on to explain that Exhibit A was rank hear-

say which did not qualify for admission. "I want it clearly understood that I have stipulated that I have no objection to the authenticity or to the identity of this thing, but I have strenuous objections on the grounds of materiality and hearsay." He particularly noted that Wixson, who identified the offered exhibit, "was not an officer of the corporation" when "the transaction took place;" that Wixson's affidavit does no more than say that "the photostat there is a true copy of minutes of a certain meeting;" and that the affidavit "attempts to state something about a loan" that "happened ten years before, when he wasn't present or knew anything about it." (R. 613-614.) In reply, counsel for the respondent stated that Exhibit A "is part of the records of the lending institution, and it has genuineness and reliability because of that." (R. 615.) In the wake of these arguments the document was received.

Both in the stipulation and at the trial, then, the petitioners unmistakably served notice that they objected to the admission of Exhibit A because it was pure hearsay. When an objection is made on the ground of hearsay, the proponent has the burden of qualifying the evidence under some exception to the hearsay rule. Therefore, Exhibit A was not admissible within the special exception for business records unless the respondent, at the very least, laid the proper foundation required in a court of law. The usual rules of evidence are not suspended in tax cases. The respondent tries hard to overcome the obvious by blandly saying that the petitioners conceded the foundation when they stipulated the "identification or authentication" of the document. (Resp. 52.) But this attempted exoneration clearly distorts the purpose and content of the stipulation. In conceding the "authenticity" or "identity" of the photostat, the petitioners merely granted that the photostat was a correct copy of the original. The concession was designed to relieve the respondent from the burden of producing and identifying

the original in court. The respondent would now convert this courtesy extended for his convenience into an advance covenant that the photostat was admissible under the business records exception. Indeed, if the petitioners had entered into any such agreement, the explicit reservation of the right to object was utterly pointless. And in distinguishing the routine records of ABC-Portland, Mr. Jones made it clear beyond doubt that in his view Exhibit A did not similarly qualify as an admissible business document. He specifically indicated that the respondent had not produced any witness who "knew anything about it." See p. 11, *supra*. He could scarcely have waived the required foundation if he, too, knew nothing about it.

In order to compensate for the lack of a foundation the respondent further states, "There is no question at all that Exhibit A is a correct copy of the minutes of the meeting in question. And the fact that corporations keep minutes would appear to be subject to judicial notice. Indeed, under the laws of Delaware, the state of incorporation of ABC-Delaware, there is a mandatory requirement that such minutes be kept." (Resp. 51-52.) These observations are quite beside the point. Of course, the petitioners stipulated that Exhibit A included a correct copy of a certain paper found among old records of ABC-Delaware. But as this Court very recently held, "The existence of a document or its presence in the file of a corporation does not, without more, render it admissible under § 1732." Nor are copies admissible simply because they are conceded to be "accurate reproductions." *Standard Oil Company of California* v. *Moore,* 251 F. 2d 188, 212, 215, n. 34 (9th Cir. 1958). See also Pet. 48-49. The situation here is no better than if Wixson had come to court and identified the writing on the stand. Since he knew nothing about its preparation, it would have been clearly inadmissible. *In re Henry Holzapfel's Sons, Inc.,* 249 F. 2d 861, 864 (7th Cir. 1958). See also Pet. 49. Sim-

ilarly, nothing is gained by saying that corporations keep minutes, and that in Delaware they are required to keep them. Corporations have all sorts of hearsay records, but that alone does not make them competent evidence. Even "under the liberal provisions" of section 1732 "it is necessary at least to submit preliminary evidence" that the purported minutes "were made in the regular course of corporate business, before they can be admitted." *Bruce* v. *McClure,* 220 F. 2d 330, 336 (5th Cir. 1955). This familiar rule applies to alleged minutes just as it applies to all other records that come out of business files. See, *e.g., Bruce* v. *McClure, supra; Spiegel's Housefurnishing Co.,* 2 B. T. A. 158 (1925).

Exhibit A was also inadmissible because it failed to satisfy the critical requirement of trustworthiness. (Pet. 50-53.) The respondent seeks to obviate this inadequacy by stating that "corporate minutes are entries made in the routine course of business. The trustworthiness of the minutes here under consideration is apparent when the circumstances are examined." (Resp. 52.) Here, as we understand it, the respondent is arguing that alleged minutes are conclusively trustworthy records kept in the course of business, though no evidence is produced which shows who prepared them, how they were prepared, and when they were prepared. Although the respondent himself apparently has no knowledge of "the circumstances" in which the minutes were put together, he is not disturbed by the slightest doubt of their reliability. See also p. 11, *supra.* As long as they purport to be minutes, they are supposedly trustworthy. Or as counsel for the respondent argued at the trial, if they are among the corporate records, they necessarily have "reliability because of that." See p. 11, *supra.* This notion of the Business Records Act speaks for itself.

Our discussion of the respondent's views on Exhibit A would be incomplete if we failed to mention this Court's instructive opinion in *Standard Oil Company of Cali-*

fornia v. *Moore, supra.* In that case a mass of writings, consisting of originals and copies, was offered in evidence. As in this case, it was "not questioned" on the appeal that the copies were "accurate reproductions" or that "the documents came from" business "files and records." The trial court admitted practically all the tendered records "under the hearsay rule which applies to business records." 251 F. 2d at 212. After a thoughtful analysis of section 1732, this Court held that the admission was reversible error. The relevant portions of that opinion are well worth repeating here.

At the outset the opinion emphasizes the basic principle of trustworthiness. "The probability of trustworthiness of memoranda and records made and maintained as provided in §1732 lies in the fact that they are routine reflections of the day-to-day operations of the business in whose files the memoranda and reports are found . . . . The matters which reflect the day-to-day operations of a commercial enterprise are those in which it is directly concerned as a participant. Illustrative of these are such matters as bids, offers, purchases, sales, deliveries, price quotations, credit extensions, loans, rentals, salary and wage payments and deductions, inventory charges, and bank deposits." 251 F. 2d at 213. Therefore, "a writing which does not pertain to a matter in which the business was a direct participant, but to some incident, circumstance, or activity outside that business, is not a memorandum or record of an 'act, transaction, occurrence, or event' within the meaning of the statute." In that case the writing is inadmissible even though "it may have been made in keeping with systematic and routine procedures." *Ibid.* A writing, the opinion significantly adds, "cannot ordinarily be considered a 'memorandum or record' of an 'act, transaction, occurrence, or event,' unless the recitals in such writing are factual in nature." While there are "special circumstances under which writings containing expressions of opinion

or conclusions'' may be admissible, these are situations where ''an opinion or conclusion calls for professional or scientific knowledge or skill,'' and ''the opinion or conclusion is expressed by one having the required special competence.'' *Id.* at 213-214.

The opinion stresses still other important aspects of the statute. ''A memorandum or record cannot be considered as having been made in the 'regular course' of business, within the meaning of §1732, unless it was made by an authorized person, to record information known to him or supplied by another authorized person.'' *Id.* at 214. Again, a memorandum or record is not deemed ''made in the 'regular course' of business,'' within the meaning of the statute, ''unless it was made pursuant to established company procedures for the systematic or routine and timely making and preserving of company records.'' *Id.* at 215. The ''procedures'' of the company ''must provide for systematic or routine entry of such records,'' and they must equally ''call for timely entry of such records.'' *Id.* at 215, n. 34. The Court concluded that the documents were erroneously admitted because their proponent had not discharged the burden of proving such procedures. He made no effort to show that ''any systematic or routine procedure'' was ''followed in the preparation and filing'' of the writings, or that ''it was a regularly established business procedure to make such memoranda or records'' in timely fashion. Hence the writings should have been excluded, for exhibits ''unsupported by foundation evidence showing adherence to company procedures calling for prompt preparation of the writing'' are ''not admissible under §1732.'' *Id.* at 215-216.

Though the exhibit here is different from those discussed in the *Standard Oil* case, the principles articulated by the Court similarly apply. Here, as we have already shown in some detail (Pet. 48-50), the record is devoid of any proof that Exhibit A derived from a systematic

procedure assuring a prompt and accurate recording of a business event. Nothing at all is known about the preparation of the exhibit. And, as we have also pointed out (Pet. 50-53), the exhibit has none of the earmarks of reliability which accompany "routine reflections of the day-to-day operations of the business." The respondent complacently assumes on his own behalf that if a writing of a corporation is found in its file, it is therefore admissible. Finally, as the *Standard Oil* opinion thoughtfully explains, in order to be admissible a writing must "pertain to a matter in which the business was a direct participant," and the writing must record some matter of fact which is relevant to the dispute. The question here is not what Davidson may have stated at a meeting within ABC-Delaware or how those present at the meeting may have reacted to what he allegedly said. The question is whether ABC-Portland made a loan to Bentson or to the petitioners. In regard to this issue Exhibit A is wholly inadmissible hearsay. (Pet. 54-55.) It does not purport to record the "act, transaction, occurrence, or event" which is involved here — the loan made by ABC-Portland. Cf. *Lomax Transportation Co.* v. *United States,* 183 F. 2d 331, 333 (9th Cir. 1950). In conspicuous contrast, the routine business entries of ABC-Portland—which the respondent himself offered in evidence and now conveniently ignores—carry Bentson as obligor on the loan. (Pet. 6-7, 54-55.) If, for some reason, Exhibit A is nevertheless considered a record of the transaction in dispute here, then it is still inadmissible. For ABC-Delaware, the parent of the lender, was not a participant in the transaction. As Wixson's affidavit indicates (Pet. 5a), ABC-Delaware dealt only with ABC-Portland — not with those who obtained loans from ABC-Portland.

At the end the respondent curtly dismisses the Tax Court's admission of Exhibit A as a mere triviality.

Even if the exhibit was wrongly received, "the error was not prejudicial." The Tax Court, he says, "rested its decision upon much more than Exhibit A." The "much more" allegedly consists of the "vagueness of interested witnesses at the time of the revenue agents' investigation," Bentson's "insufficient" net worth, "the securing of all the capital stock of Stages for the loan," and "the signing of the note by E. Royce." (Resp. 53.)

There are three short answers to this plea that the Tax Court's error be forgiven and forgotten — so that the respondent may collect heavy income taxes on $350,000 despite the error. In the first place, none of the items enumerated by the respondent is a scintilla of proof that Niederkrome, B. Royce, Jacob, or Schneider owned any of the 350 shares or borrowed any of the $350,000. (Pet. 33-43; pp. 3-8, *supra*.) Similarly, though E. Royce undoubtedly signed the note, the testimony is uncontradicted that he signed as accommodation maker. The additional items which are deemed "much more" evidence are no more illuminating as to E. Royce than they are in regard to the others. (Pet. 43-44.) In the second place, the Tax Court obviously appraised Exhibit A as the critical evidence that was "much more reliable" than the petitioners' testimony, which concededly indicated that "Bentson applied for and was granted a loan of $350,000 by ABC to provide him with cash to make the purchase." (R. 240-241.) Indeed, it was Exhibit A which led the Tax Court to infer that Bentson could not have been in Portland when the loan was negotiated (R. 241-242) — though Jacob firmly testified that he introduced Bentson and E. Royce to Davidson. (Pet. 34, 39.) In the third place, even if the Tax Court might conceivably have sustained the deficiencies without Exhibit A, that consideration is completely irrelevant. A decision of the Tax Court cannot stand if it is substantially based on inadmissible evidence. "Its action must be measured

by what" it "did, not by what it might have done." Cf. *Securities Commission* v. *Chenery Corp.,* 318 U. S. 80, 93-94 (1943). It is not for the respondent to tidy up a decision of the Tax Court if that Court has seriously erred. As Judge Denman wrote for this Court, even when there is evidence "which adequately supports" the trial court's conclusions, the judgment must be reversed if the court also used evidence that was "entitled to no consideration." It is immaterial that "the trial court could have made the same finding on the evidence which was properly admitted." *Smallfield* v. *Home Insurance Co. of New York,* 244 F. 2d 337, 341 (9th Cir. 1957). Cf. *Olender* v. *United States,* 210 F. 2d 795, 808-809 (9th Cir. 1954); *Hartzog* v. *United States,* 217 F. 2d 706, 711 (4th Cir. 1954).

Our view of the respondent's effort to revise the decision below is fortified by his method of evaluating evidence. If a taxpayer does not take the stand, the respondent promptly says that his failure to do so creates a serious inference against him. But if the taxpayer takes the stand — as all five petitioners did here — the respondent just as readily disparages the testimony as unworthy of belief because it comes from an interested witness. (Resp. 45.) Apparently, it is impossible to satisfy the respondent. On the other hand, the respondent's own agents are regarded as necessarily disinterested witnesses whose testimony is inherently above suspicion. (Resp. 46-47.)

5. In accordance with this Court's decisions in *Earle* v. *Woodlaw,* 245 F. 2d 119, 122 (9th Cir. 1957), *cert. denied,* 354 U. S. 942 (1957); and *Pacific Vegetable Oil Corp.* v. *Commissioner,* 251 F. 2d 682, 683 (9th Cir. 1957), the respondent agrees that "the ultimate question of whether the distribution was essentially equivalent to a dividend" presents a question of law for review. (Resp.

48.)[4] However, he then adds that "the determination that the taxpayers herein and not Bentson incurred this indebtedness is a simple question of fact and the record is replete with evidence in support of it." (Resp. 48.) The respondent's appraisal of the issues oversimplifies matters.

The Tax Court erred as a matter of law in concluding that the petitioners owned the 350 shares and borrowed the $350,000. As our examination of the record shows, if we put Exhibit A aside for the moment, there is no proof that Bentson served as a "dummy" or "straw" for the petitioners. (Pet. 33-57; pp. 2-8, 17, *supra.*) In final analysis, the Tax Court was critically influenced by Exhibit A; but even if that exhibit was admissible, the Court was unduly impressed. With respect to Niederkrome, B. Royce, Jacob, and Schneider, the exhibit proves precisely nothing. At most it refers only to E. Royce as a proposed applicant for a loan. (Pet. 36-38.) The Tax Court itself said, on the basis of Exhibit A, "Clearly the loan was made to E. Royce." (R. 240.) However, the exhibit is equally ineffective against E. Royce, though we again assume that it was rightly received. "Mere uncorroborated hearsay" is not "substantial evidence" endowed with the required "rational probative force" to sustain a judgment. *Edison Co.* v. *Labor Board,* 305 U. S. 197, 230 (1938).[5]

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[4] See also *Northup* v. *United States,* 240 F. 2d 304, 307 (2d Cir. 1957), which holds that since this issue involves "the application of a statutory rule to found facts," it is "precisely the kind of question it is our function to decide." Cf. *Weible* v. *United States,* 244 F. 2d 158, 161 (9th Cir. 1957); *Electric Materials Co.* v. *Commissioner,* 242 F. 2d 947, 949 (3d Cir. 1957).

[5] In this connection the respondent states: "The taxpayers would have this Court view the stock redemption in a vacuum, without any consideration whatsoever of the long series of interrelated transactions;" and that the Tax Court "refused to adopt the narrow attitude espoused by taxpayers and found it necessary to consider all of the facts involved." (Resp. 44.) These rhetorical observations are mere question-begging. The petitioners are not seeking a decision on the basis of "a vacuum," as distinguished from "all of the facts." The problem here is that the respondent would reject legal proof in favor of surmise and conjecture.

We may appropriately go one step further. The record does not present any conflict in oral testimony; and once Exhibit A is removed, no question of credibility remains. Each of the five petitioners testified clearly and cogently that Bentson bought the 350 shares and borrowed the $350,000 on his own behalf. None of this testimony was contradicted. Since the witnesses were not "otherwise impeached" and their testimony was not "inherently improbable," it "cannot be disregarded" even though each of the five is "an interested party." *Wener* v. *Commissioner,* 242 F. 2d 938, 944-945 (9th Cir. 1957). See further *Penna. R. Co.* v. *Chamberlain,* 288 U. S. 333, 340-341 (1933); *Nicholas* v. *Davis,* 204 F. 2d 200, 202 (10th Cir. 1953); *Indialantic, Inc.* v. *Commissioner,* 216 F. 2d 203, 205 (6th Cir. 1954); *Sharaf* v. *Commissioner,* 224 F. 2d 570, 572 (1st Cir. 1955); *Benton* v. *Blair,* 228 F. 2d 55, 61 (5th Cir. 1955). Besides, their testimony was corroborated by the respondent's own witnesses. See pp. 3-8, *supra.* As a result, the Tax Court's conclusion that Bentson was a mere "straw" cannot stand.

The remaining question on review involves the proper application of section 115 (g). If Bentson owned the 350 shares that were turned in, the distribution in redemption of those shares did not fall within the statute. (Pet. 29-30.) We further contend that the result is the same as a matter of law even if the petitioners, rather than Bentson, are considered the owners of the shares. (Pet. 64-74.)

6. The respondent seems to suppose that once Bentson is disregarded, section 115 (g) inevitably applies. He rationalizes this legal conclusion primarily in terms of three considerations: (1) the pro rata character of the redemption;[6] (2) the lack of dividend distributions to the petitioners; and (3) the absence of any business purpose for

[6] The Tax Court, however, held that the redemption altered the relative interests of the stockholders. (Pet. 43.)

the redemption, such as a contraction of the enterprise. (Resp. 54-58.) If we assume for the sake of argument that Bentson can be ignored, the respondent's conclusion scarcely follows as unavoidably as he thinks.

According to the respondent's own regulations, a pro rata redemption is only "generally" considered a distribution equivalent to a dividend. Whether the required equivalence exists "depends" always "upon the circumstances of each case." Regulations 111, § 29.115-9. For the reasons developed in our principal brief, the redemption in the special circumstances of this case was not akin to a dividend — though the respondent's view of Bentson's participation is otherwise accepted as correct. Even on the respondent's understanding of the facts, the net effect was not a distribution of a dividend, but a purchase of the corporate equity less the value represented by the 350 shares. (Pet. 64-74.) The other two factors cited by the respondent are also unimportant in the present context. The dividend history of a corporation is usually relevant because section 115 (g) is concerned with stockholders who would avoid tax by accumulating profits within the corporation and then withdrawing them through a redemption. In such circumstances the lack of dividends in prior years may well be informative. Here, however, the amount distributed does not consist of earnings which the petitioners previously hoarded over the years within the corporate walls. The surplus was accumulated by others. The presence or absence of business purpose is similarly insignificant here. Business purpose is at best relevant because it may indicate that a redemption which is otherwise within section 115 (g) was not a mere device to distribute corporate earnings. Compare, for example, *Earle* v. *Woodlaw, supra.*[7] But as we have just noted, even under the respondent's view of the facts, the redemption here is not otherwise equivalent to a dividend.

[7] But see *Northup* v. *United States, supra,* at 307.

7. The respondent dismisses our claim that the Tax Court erroneously treated the presumption of correctness as evidence to be weighed in the balance. (Pet. 59-64.) He states that any "attempt to argue that the Tax Court did not consider the Commissioner's evidence but rather relied upon the presumption is to ignore the extensive findings of fact made by the Tax Court." (Resp. 60.) The respondent is answering an argument which we never made. We do not deny that the Tax Court relied in part on what it appraised as persuasive evidence. Our point, rather, is that here, as in *Hemphill Schools* v. *Commissioner,* 137 F. 2d 961 (9th Cir. 1943), the Tax Court also relied in part on the presumption. It did not derive its conclusion "from the evidence, and from it alone." *Id.* at 964.

II. Hippodrome Amusement Company

1. Here, again, the respondent is somewhat lax in summarizing the evidence. For example, he states that Niederkrome "worked under E. Royce and followed his instructions and orders." (Resp. 61.) The evidence to which he refers (R. 519) relates to the Yellow Cab Company of Portland and not to Hippodrome.[8] In similar fashion the respondent asserts that E. Royce "simply requested the money and it was given to him, admittedly a normal procedure in the conduct of the affairs of the corporation." (Resp. 61.) No evidence is cited for this colored observation, and understandably so. There is no such evidence in the record. The respondent also infers too much from the record when he says that Hippodrome's "financial and operating condition would have warranted the distribution of dividends." (Resp. 62.) The Tax Court made no such finding. It merely held that the earned surplus was about $20,000 when the corporation disbursed $20,000 to E. Royce. (R. 260.) And it did not

[8] The Tax Court similarly misconstrued the evidence. (R. 258.) However, the Court at least summarized it more accurately.

suggest that the disbursement was artfully designed as a substitute for a dividend. As a matter of arithmetical fact, the corporation did not have enough accumulated earnings to pay a dividend of $20,000 to E. Royce and proportionately lesser dividends to the other three stockholders.

2. The Tax Court gave two reasons for its refusal to treat the disbursement of $20,000 as a loan in accordance with the documentary and oral evidence. (R. 262.) We have indicated that neither ground provides an adequate basis for its conclusion. (Pet. 79-81.) It seems that even the respondent is not too pleased with the reasons advanced by the Tax Court; for he has now tried to supply still another ground which never occurred to that Court. The respondent points to the petition of E. Royce, which alleged that Hippodrome was accumulating funds in order to construct a building for Oregon Motor Stages, and that the $20,000 was loaned to E. Royce until the "building program could be put into effect." (R. 70-71.) He then says that there were no such plans in 1945, when the disbursement was made, and therefore "such a factor was of no relevance whatsoever in determining whether or not a loan was made in 1945." (Resp. 62, 64-65.)

This argument is carefully concerned with the irrelevant. Three witnesses fully summarized the circumstances of the advance and the terms of the advance. Their testimony is uncontradicted, as well as supported by the pertinent records. The absence of a building program in 1945 hardly illuminates the narrow question whether E. Royce intended to repay the $20,000 and whether he was expected to repay it. A loan by a corporation to a stockholder does not become a dividend because the corporation has not yet definitively decided how to use its funds. It is not surprising that the Tax Court failed to adopt the argument which the respondent now offers. At any rate, the merits of the Tax Court's legal conclusion are to be appraised in the light of the

Tax Court's reasoning. The respondent cannot reconstruct the opinion and then impute the revision to the Tax Court.

3. We gather that the opinion below troubles the respondent in another respect. The Tax Court held that the disbursement of $20,000 was a dividend, though Hippodrome had four shareholders and three of the four, who owned about 40 percent of the stock, received nothing. No attempt was made to explain how this kind of disproportionate payment resembles a dividend. (Pet. 81-82.) Therefore, the respondent again tries to improve upon the Tax Court's opinion. He cites eight decisions to sustain his view that such a disproportionate withdrawal is a dividend. (Resp. 64.) The decisions, however, do not say what he has attributed to them.

Of the eight decisions, three do not remotely involve the question whether a withdrawal is a loan or a dividend.[9] The remaining five are *Chattanooga Sav. Bank* v. *Brewer,* 17 F. 2d 79 (6th Cir. 1927), *cert. denied,* 274 U. S. 751 (1927); *Hadley* v. *Commissioner,* 36 F. 2d 543 (D. C. Cir. 1929); *Christopher* v. *Burnet,* 55 F. 2d 527 (D. C. Cir. 1931); *Anketell Lumber & Coal Co.* v. *United States,* 1 F. Supp. 724 (Ct. Cls. 1932); *Regensburg* v. *Commissioner,* 144 F. 2d 41 (2d Cir. 1944), *cert. denied,* 323 U. S. 783 (1944). In the *Chattanooga* case the stock was owned by two individuals, and the withdrawals for the year were in exact proportion to their holdings. The Sixth Circuit particularly emphasized that the withdrawals were precisely related to the respective interests, and that the charter prohibited loans to stockholders. In the *Hadley* case there were three stockholders who owned 105, 94, and 1 shares, or a total of 200. The corporation made informal distributions, of which the smallest stock-

[9] These three are *Cleveland Shopping News Co.* v. *Routzahn,* 89 F. 2d 902 (6th Cir. 1937); *Paramount-Richards Theatres* v. *Commissioner,* 153 F. 2d 602 (5th Cir. 1946); *58th St. Plaza Theatre* v. *Commissioner,* 195 F. 2d 724 (2d Cir. 1952).

holder received 1/200 while the other two shared the balance equally. The Commissioner determined that the amounts received by the stockholder owning 94 shares were taxable as dividends only to the extent that they did not exceed his proportionate share of the earnings. He conceded that the balance was not a dividend. Moreover, the question in the case was not whether a withdrawal was a loan, but whether a dividend required a formal declaration. In the *Christopher* case the taxpayer was the sole stockholder. In the *Anketell Lumber* case the taxpayers were husband and wife, who owned over 95 percent of the stock and controlled the balance as trustees. The corporation was in liquidation, and they made withdrawals in proportion to their holdings.

Finally, the *Regensburg* decision is no more helpful to the respondent than the other cases which he has so strangely cited. In fact, it indicates that the Tax Court has erred here. The case involved a family corporation organized in 1903. The taxpayers were four brothers, and the taxable years were 1936-1940. During those years the taxpayers and another brother owned 92.5 percent of the stock. See 1 T. C. M. 925, 926 (1943). Over a prolonged period of 38 years the taxpayers withdrew tremendous sums of money. Their respective net balances at the end of 1940 were $250,053, $398,919, $749,388, and $1,677,671. The withdrawals from year to year "were made at will." 144 F. 2d at 42-43. Or, as the Tax Court summarized the situation, "From the beginning" the taxpayers, "as a practice, had withdrawn" the corporation's "funds on an open running account without regard to the mathematical relation between the withdrawals and their respective shareholdings. The individual withdrawals were at pleasure and without previous consultation among them." 1 T. C. M. at 928.

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In view of this continuing pattern over four decades the Second Circuit held that the withdrawals in 1936-1940 were taxable as dividends. "If the sums withdrawn

were actually intended to be loans," the Court reasoned, "it seems extraordinary that they should have been allowed to roll up for nearly forty years until they reached the staggering total of more than $3,000,000 owing by persons who had nothing but their shares of stock with which to pay." The alleged indebtedness of each taxpayer "was greater than the value of his shares." In the case of one taxpayer "his debit balance of $1,677,-671 was greater than the book value of his stock even when computed with" the alleged outstanding loans "included at full value." Noting that the amounts withdrawn were unequal, the Court stated, "Some measure of assurance that the amounts might ultimately be evened up was furnished by" an agreement "which provided that if the shares were sold the seller's indebtedness to the corporation should be taken out of the purchase price. Thus the other shareholders assured themselves of an even distribution of earnings in so far as the value of the shares could effect it." 144 F. 2d at 44. As the Tax Court expressed the same conclusion, "a consistent practice in a family corporation of withdrawing the corporation's earnings on an open account, with only negligible repayments in almost the entire forty years of the corporation's existence, indicates an established method of dividend distribution . . . ." 1 T. C. M. at 929.

The respondent's reference to the *Regensburg* case aptly illustrates how far afield he has gone in search of some supporting authority. Here there were no continuing withdrawals at will from one year to another. Here there was no "consistent practice" of removing earnings "at pleasure" from "a family corporation." The recorded loan was no more than an isolated advance by a corporation to a stockholder after due consultation with others who had a stake in the enterprise. The money was to be returned as soon as the corporation needed it. (Pet. 9-11.) However, the *Regensburg* decision is not only easily distinguishable. Even more

important, it pointedly disapproves the reasoning to which the Tax Court resorted here.

The Tax Court justified its conclusion on the ground that the advance of $20,000 was much less than E. Royce's net worth, and that it was unaware of any "valid or persuasive reason" for a loan. (R. 262; Pet. 79-80.) On the other hand, the Second Circuit emphasized that the withdrawals before it were essentially dividends precisely because they far exceeded the stockholders' net worth. In effect, the Tax Court has reversed the Second Circuit's reasoning. A stockholder's ample ability to return a corporate advance is regarded as a rational basis for treating an advance as a dividend rather than a loan.[10] The departure from the *Regensburg* case does not end there. In the same case the Second Circuit also held that the stockholder's particular purpose in obtaining the loan was immaterial. The Tax Court had allowed Government counsel to establish, on cross-examination, that part of the withdrawals "was used in race-track gambling." 144 F. 2d at 44. The Second Circuit reproved the Tax Court for permitting this inquiry into purpose. "We cannot see," the Court wrote, "that the use which the taxpayers made of the money was relevant to the issue whether it was withdrawn as a loan or a distribution of earnings; whichever it was the taxpayer was privileged to use it as he pleased. Nor do his gambling losses throw light on his intention to repay. Some men will gamble in the hope of getting funds with which to pay their debts, while others will not risk a bet if any debts hang over them." *Id.* at 44-45. In dwelling on E. Royce's reason for obtaining the advance, the Tax Court went clearly astray.

4. The respondent suggests that the question whether the disbursement to E. Royce was a loan or a dividend is merely an issue of fact. (Resp. 63.) This view of the

[10] The respondent, too, persists in this odd reasoning. (Resp. 66.)

matter does not accurately reflect the question before the Court.

As the Supreme Court has said, there are "facts and facts." *United States* v. *Felin & Co.,* 334 U. S. 624, 639 (1948). "The conclusiveness of a 'finding of fact' depends on the nature of the materials on which the finding is based. The finding even of a so-called 'subsidiary fact' may be a more or less difficult process varying according to the simplicity or subtlety of the type of 'fact' in controversy. Finding so-called ultimate 'facts' more clearly implies the application of standards of law." Hence "the conclusion that may appropriately be drawn from the whole mass of evidence is not always the ascertainment of the kind of 'fact' that precludes consideration" on appeal. *Baumgartner* v. *United States,* 322 U. S. 665, 671 (1944). In short, there is a sharp distinction between "ascertainment of the historical facts" and "interpretation of the legal significance of such facts." *Brown* v. *Allen,* 344 U. S. 443, 507 (1953). An issue of fact, as correctly understood for purposes of review, involves "findings of primary, evidentiary or circumstantial facts." *Helvering* v. *Tex-Penn Co.,* 300 U. S. 481, 491 (1937); *Bogardus* v. *Commissioner,* 302 U. S. 34, 39 (1937). It "does not cover a conclusion drawn from uncontroverted happenings" when the conclusion incorporates legal criteria or standards of judgment. See *Watts* v. *Indiana,* 338 U. S. 49, 51 (1949). For then the findings "are inescapably enmeshed in considerations that are clearly familiar issues of law." *United States* v. *Felin & Co., supra,* at 639. See also *Powers* v. *Commissioner,* 312 U. S. 259, 260 (1941); *Offutt* v. *United States,* 348 U. S. 11, 15 (1954); *Galena Oaks Corp.* v. *Scofield,* 218 F. 2d 217, 219 (5th Cir. 1954).[11]

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[11] In *Commissioner* v. *Lo Bue,* 351 U. S. 243 (1956), the Supreme Court recently applied the basic distinction just summarized. The question was whether an employee realized income by exercising options to purchase stock in his corporate employer. The Tax Court held that no income was realized

The record here is free of any evidentiary debate. All the evidence, oral and written, indicates that the disbursement was made as a loan. (Pet. 77-79.)[12] Nevertheless the Tax Court concluded that it was a dividend. And the Court reached this result through the process of applying erroneous criteria of judgment. (Pet. 79-81; pp. 23, 27.) Therefore its conclusion is reversible as a matter of law.

III. Portland Partnership — Dora F. Royce

1. The respondent seems to proceed on the assumption that the concept of partnership in income tax law is different from the concept of partnership in ordinary commercial law. (Resp. 67-68.) But as we have already shown, there is no such distinction. If individuals "are in the same business boat" apart from taxes, "they do not cease to be in it when the tax collector appears." (Pet. 83-84.) Or, as the Tax Court recently agreed with the respondent, for income tax purposes the controlling criteria of so-called family partnerships are the same as those of all other partnerships. See *Beck Chemical Equipment Corp.*, 27 T. C. 840, 848-853 (1957).

2. In our principal brief we contended that Dora qualified as a partner on either of two grounds: (1) she owned a capital interest in the firm (Pet. 89-90); and (2) she contributed services to the firm. (Pet. 90-92.) In an effort to disparage Dora's capital interest the respondent argues that the acquisition of her interest was "contingent upon her joining" the partnership; (Resp.

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because the option was granted in order to give him "a proprietary interest in the corporation, and not as compensation for services." The Third Circuit affirmed on the ground that the Tax Court's determination resolved a factual issue and was not "clearly erroneous." *Id.* at 245-246. The Supreme Court reversed because the finding derived from an erroneous legal standard. *Id.* at 247. Cf. *Commissioner* v. *Culbertson*, 337 U. S. 733, 741-748, 749-750 (1949).

[12] As elsewhere in his brief, the respondent belittles the testimony of three witnesses on the ground that they were "interested." See, however, p. 20, *supra*.

73-74); that there were no specific "business purposes" for having her join (Resp. 74-75); and that E. Royce "controlled the partnership earnings" distributed to her. (Resp. 77-78.) Each of these arguments is what Mr. Justice Holmes called mere "spider's webs inadequate to control the dominant facts." *Myers* v. *United States,* 272 U. S. 52, 177 (1926).

If Dora's capital interest was otherwise real, it is immaterial that E. Royce expected her to become a partner when he gave her the interest. (Pet. 90, n. 36.) The respondent adds little when he states that E. Royce ultimately decided that she should have an interest. (Resp. 73-74.) Obviously, a donee of property cannot acquire it unless the donor is prepared to part with it. Nor does the respondent move any further when he speaks of so-called "business purpose." It is well settled that an individual may become a partner, through the acquisition of a capital interest or a contribution of services, regardless of whether his becoming a partner enhances the business. (Pet. 88, n. 35.) We are only saying what the respondent himself has said. "There is no requirement that intra-family gifts be motivated by a business purpose, which frequently they would not have, before the donee may be recognized as the owner, for income tax purposes, of the property given to him, and the same is true of other antecedent family transactions." Mim. 6767, 1952-1 Cum. Bull. 111, 117, considered at Pet. 88. See also Pet. 86-87, 90, n. 37. As the Sixth Circuit has stated, in referring approvingly to Mim. 6767, the "only question is whether the individual has really" made the gift or other transfer. *Henslee* v. *Whitson,* 200 F. 2d 538, 540 (6th Cir. 1952). See also *Whayne* v. *Glenn,* 222 F. 2d 549 (6th Cir. 1955), *rev'g* 114 F. Supp. 784 (W. D. Ky. 1953), because the trial court had erroneously required a "business purpose" for a partnership. Unfortunately, the present case is still another example of what too often occurs in taxation. The respondent says

one thing for purposes of administration, and then says exactly the opposite for purposes of litigation.[13]

The respondent's third point is that E. Royce "controlled the partnership earnings distributed to his wife." (Resp. 77.)[14] The evidence merely shows that a number of years after Dora joined the Portland partnership, she loaned E. Royce $70,000 for investment in a mining project. (Pet. 14-15, 92-93.) Certainly, a loan from a wife to a husband does not establish that the husband had the power to do as he pleased with his wife's estate. (Pet. 92-93.) The respondent attempts to bolster his exaggerated view of the evidence by noting that E. Royce endorsed many of the distribution checks payable to Dora. (Resp. 77.) However, E. Royce fully explained that the bank tellers required his signature on the checks cashed by her. (R. 610.) And, in any event, as the respondent tacitly admits through silence, E. Royce's endorsements did not reflect any actual use or diversion of her share of partnership earnings. The respondent's complaint against Dora's interest as a partner can only begin and end with the one loan made by Dora to her husband. But such a complaint is no legal argument at all. The loan was "made by her with her own money and by her own free choice." Cf. *Nick L. Spada,* 9 T. C. M. 541, 545 (1950). The important consideration is that she was able to do as she pleased. (Pet. 92-93.)

3. Despite the abundant evidence that Dora actively contributed services to the business, the respondent con-

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[13] The respondent insinuates that Dora was made a partner simply to reduce income taxes. (Resp. 75.) There is no such suggestion in the Tax Court's opinion, nor is there an iota of evidence to this effect. E. Royce testified on cross-examination that he gave Dora an interest in the firm because "she was of so much help to me." He "felt morally obligated to do it." (R. 450.)

[14] The respondent errs when he states that Dora's expenditures totalled "no more than $39,900." (Resp. 77.) He has overlooked her purchase of a Plymouth and a Cadillac, various furnishings for the home, and several hundred dollars' worth of books. (Pet. 14-15.)

tends "that except for occasional discussions with her husband she was never actively engaged in the business." Dora's "interest in the business," he declares, "was no more than that of any wife in her husband's enterprises." (Resp. 76.) There is no need for any detailed analysis of these statements. The evidence to which we have already referred sufficiently disposes of the respondent's understanding of the record. (Pet. 12-13, 90-94.) Until now we had not supposed that serving steadily as a checker of cabs and drivers revealed "no more" than the "interest" of "any wife in her husband's enterprises."[15]

The Tax Court did not disagree that Dora rendered services to the business. And it found that the services were the same as those regularly performed by an employee in the business. (R. 272, 277.) It simply refused to recognize the services as valuable, though it had no "knowledge of and experience with the particular subject under consideration." *Boggs & Buhl* v. *Commissioner,* 34 F. 2d 859, 861 (3d Cir. 1929). See also *Planters' Operating Co.* v. *Commissioner,* 55 F. 2d 583, 586 (8th Cir. 1932). In so doing, it committed error. (Pet. 90-92.)

4. The respondent states, "In this as in many other fields of taxation it is the substance of the matter which is controlling." (Resp. 69-70.) We have no inclination to question this principle, even though elsewhere the respondent seems reluctant to apply it. (Pet. 66-70.) The "substance" is that Dora acquired an interest in the firm as a partner. Her interest was not a "mere camouflage" which left E. Royce's prior interest un-

[15] The respondent tries to make something of Dora's momentary failure to recall, at one point in cross-examination, some decision made at the business conferences. (Resp. 76, n. 13.) But the evidence is clear that she joined in such conferences. For example, she testified that she participated in a conference concerned with the question of hiring women drivers. She was not in favor of hiring them, but was out-voted. (R. 536.) Furthermore, through her capital interest and her services Dora qualified as a partner, whether or not she also shared in top management and control.

disturbed. See *Commissioner* v. *Culbertson,* 337 U. S. 733, 746-747 (1949). As this Court has very explicitly declared, partnership income is taxable to "the real owner of the partnership interest;" and "this has always been the law." *Toor* v. *Westover,* 200 F. 2d 713, 716 (9th Cir. 1952). If Dora had acquired an equivalent interest in a corporate enterprise, her ownership would clearly be recognized for tax purposes. Her ownership was not less genuine because the business was carried on through a partnership. A gift of a corporate interest and a gift of a partnership interest are subject to the same rules. See *Williamson* v. *United States,* 152 F. Supp. 716, 719 (Ct. Cls. 1957).

5. According to the respondent, the Tax Court's refusal to recognize Dora as a partner presents no more than an issue of fact. (Resp. 80.) Here, too, he has misconceived the scope of the question subject to review here. See pp. 27-28, *supra.* What the parties actually did is, of course, an issue to be resolved by the triers of fact. But the legal effect of their acts — whether Dora acquired an interest as a partner — "is open for determination here unfettered by findings and rulings below except for the weight of the intrinsic authority of all lower court opinions." See Frankfurter, J., concurring in *Deputy* v. *duPont,* 308 U. S. 488, 499 (1940). The "controlling question" is "one of law." *Lawton* v. *Commissioner,* 164 F. 2d 380, 383 (6th Cir. 1947). It makes no difference if the legal conclusion is called an ultimate finding. For "it is well settled that such a finding is but a legal inference from other facts and as such is subject to review free of the restraining impact of the so-called 'clearly erroneous' rule." *Lehmann* v. *Acheson,* 206 F. 2d 592, 594 (3d Cir. 1953). Therefore, the Court is "free to draw" its own "inferences and conclusions" from the "findings of fact." *Western Union Telegraph Co.* v. *Bromberg,* 143 F. 2d 288, 290 (9th Cir. 1944). See also *United States* v.

Munro-Van Helms Company, 243 F. 2d 10, 12 (5th Cir. 1957).

"There is no significant dispute as to the basic facts pertinent to the decision." *United States* v. *duPont & Co.,* 353 U. S. 586, 598, n. 28 (1957). The only problem is whether the Tax Court appropriately applied the governing legal criteria. See *Consolidated Naval Stores Co.* v. *Fahs,* 227 F. 2d 923, 925, 927 (5th Cir. 1955). The Tax Court found that an "adequate" partnership agreement was "drawn up and signed;" that E. Royce gave Dora "capital" which "was turned in;" that she performed services normally rendered by an employee; and that she received her share of the distributions. (R. 272-273, 277.) In concluding that Dora was nevertheless not a partner, the Tax Court erred as a matter of law. (Pet. 94-95.)

IV. Seattle Partnership — Dora F. Royce

1. We have contended that Dora's interest in the Seattle partnership is beyond question because both she and her husband were essentially passive investors. (Pet. 96.) The respondent has not pointed to any error in our analysis. See further p. 38, *infra.*

2. As on the issue involving Oregon Motor Stages, the respondent belittles the testimony of Dora and E. Royce as evidence "of very interested witnesses." (Resp. 76.) We have already commented on this mode of evaluating testimony under oath which stands uncontradicted. See pp. 18, 20, *supra.* Here we need only add that the evidence of Dora and E. Royce was reinforced by the testimony of A. E. Wenck, a disinterested witness who was managing partner of the Seattle firm. (R. 615-618, 621.) Counsel for respondent refrained from cross-examining Wenck (R. 621), and produced no testimony of his own. The Tax Court could not discard "the unimpeached testimony" of the three witnesses. See p. 20, *supra.*

V. Seattle Partnership — Trust for Eunice M. Royce

1. The respondent makes a few arguments which particularly relate to the trust for the benefit of Eunice. One of these arguments is that the trust should not be recognized as a partner because of the broad powers residing in E. Royce as trustee. This contention is no more than a renewed effort to treat the trust as a sham—an untenable position which we have already discussed. (Pet. 102-103.)[16]

Our position is further buttressed by the Sixth Circuit's recent decision in *Estate of Hamiel* v. *Commissioner,* 58-1 U. S. T. C. ¶ 9422, *rev'g* 15 T. C. M. 1225 (1956). There, also, the Tax Court regarded a trust as a shell, and was seriously criticized for doing so. In that case the grantor established a trust for his minor child. Shortly after the trust was created, the trustee died. No successor was appointed for almost five years. Meanwhile the grantor administered the trust assets. As in the present case, no fiduciary returns were filed, but the grantor "himself filed income tax returns in the name of, and for," the child. Throughout "the period in which no trustee was in existence," the grantor carried the income as an account payable on his books. "The Tax Court found that the assets comprising the corpus of the trust were retained and used by the grantor in a partnership; that they remained under his control and domination; that no fiduciary returns were ever filed for the trust; that no payment was made to the trustee for the use of the assets; that the income was not treated by the grantor as trust income, but as personal income of the minor son; and that, for a long period of time,

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[16] The respondent says that the trust instrument "did not require any payment over to Eunice." (Resp. 79.) Eunice had a vested interest in the trust corpus. If the corpus was not paid to her after she became 35, it was to pass to her estate. *Winslow* v. *Rutherford,* 59 Ore. 124, 114 Pac. 930 (1911). See also *Chase* v. *Benedict,* 72 Conn. 322, 44 Atl. 507 (1899); *Chauncey* v. *Francis,* 181 Mass. 513, 63 N.E. 913 (1902); *Taylor* v. *Richards,* 153 Mich. 667, 117 N.W. 208 (1908).

there was no trustee in existence. These circumstances, the Tax Court declared, warranted a holding that the trust was a sham."

The Sixth Circuit made short shrift of the Tax Court's reasoning. A "valid trust," the Court of Appeals stated, "cannot be invalidated by the unilateral act of the grantor unless he is given that right in the trust instrument — and the grantor did not have that right in the instrument before us." "The beneficiary never agreed to surrender his rights in the trust. The trust was entirely valid at the time of its creation. There was no way in which the grantor, himself, could invalidate it. His retention of the corpus of the trust or its income, or the use thereof, would not result in the trust's being invalid. In such instances, the grantor would become, and would be held a constructive trustee." The Court added, "Even where a settlor of a trust grants himself, as trustee, the same power to deal with the trust property as he possessed before the establishment of the trust, that fact does not empower him to use the trust property for his own personal advantage and gain, so as to render income therefrom taxable to him; and no construction should be placed upon a trust agreement which would impute culpability to the trustee, or destroy the trust instrument itself, unless no other construction is permissible."

The respondent is seeking to do here what the *Hamiel* opinion says he cannot do. He is attempting to disregard a valid trust on the basis of alleged irregularities in its administration. As other decisions have also indicated, the income of a trust is not taxable to its grantor on such grounds. (Pet. 103.)

2. The Tax Court cited a group of cases to sustain its conclusion that the trust did not qualify as a partner. (R. 287.) In our view all these decisions are out of place here. None of them involved a donor-partner who, as in

the present case, was simply an inactive investor in an enterprise managed and operated by others. (Pet. 97-98, 103-105.) In the light of our criticism the respondent now cites three additional decisions in support of the Tax Court. (Resp. 80.) These decisions are *Smith* v. *Westover,* 237 F. 2d 201 (9th Cir. 1956); *Parker* v. *Westover,* 248 F. 2d 490 (9th Cir. 1957); and *Harvey* v. *Commissioner,* 227 F. 2d 526 (6th Cir. 1955). None of the three is concerned with a situation akin to the present context.

The *Smith* opinion dealt with two trusts established by husband and wife for their children. The husband exercised "absolute control of the business." He and the wife could freely fix the amount of their salaries before determining net profits available for distribution. They also retained the power to reacquire the trust interests at book value by withdrawing the trusts from the partnership. 237 F. 2d 202-203. In the *Parker* case the taxpayers were similarly husband and wife, who allegedly transferred 25 percent of their business to their children. The husband "continued as manager of the business," and made all decisions "concerning the management of the enterprise and the withdrawal of earnings." "With a minor exception, all earnings were left to accumulate in the business." To complete the picture, he was the only partner who rendered services to the enterprise, and all the income allocated to the children was earned by him. 248 F. 2d at 491-492. The *Harvey* case involved trusts which a father had created for his children. The Sixth Circuit held that the income of the trusts was taxable to him because he had reserved autocratic control in a non-fiduciary capacity. The Court carefully distinguished the case where the grantor is trustee and is "accountable for the faithful discharge of his trust." Since the grantor was not the trustee, he "was not so accountable." 227 F. 2d at 527.

The situation here was markedly different from the cases just summarized. (Pet. 97-98.) This "is not a case where the father actually earned income by his services and allowed his children to enjoy it." *Estate of A. C. Hewitt,* 9 T. C. M. 383, 386 (1950). E. Royce was but one of ten partners in the Seattle firm. (Pet. 17.) Like the the trust, he was only a passive investor. None of the income was attributable to his personal services. Since his interest was but 5 percent (Pet. 95-96), he had no peculiar control over distributions from the partnership. And the trust received its share of the distributions along with the other partners. As the Supreme Court held in *Commissioner* v. *Tower,* 327 U. S. 280, 288 (1946), the statutes of Congress are "designed to tax income actually earned because of the capital and efforts of each individual member of a joint enterprise." Here the income in question was not attributable to either the "efforts" or the "capital" of E. Royce. See also *T. W. Rosborough,* 8 T. C. 136, 146 (1947); *Edna Jurgensen,* 9 T. C. M. 1027, 1029 (1950).

Respectfully submitted,

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No. 15724

In the United States Court of Appeals for the Ninth Circuit

FRED C. NIEDERKROME, E. ROYCE, DORA F. ROYCE, EZRA ROYCE, B. ROYCE, Estate of ISABELLE H. ROYCE, Deceased, B. ROYCE, Executor, ROBERT T. JACOB, AGNES C. JACOB, ALBERT L. SCHNEIDER and BERTHA SCHNEIDER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petitions for Review of the Decisions of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court are not officially reported. (R. 216-296.)

JURISDICTION

These petitions for review (R. 303-311) involve federal income taxes. Each notice of deficiency was mailed by the Commissioner of Internal Revenue on September 28, 1953, and in each instance the tax-

payer filed a petition with the Tax Court for redetermination within ninety days thereafter.

Tax Court Docket No. 51491. A notice of deficiency was mailed to the taxpayer Fred C. Niederkrome in the amount of $32,348.48 and $1,940.07 penalty for the taxable year 1945. (R. 22-28.) On December 15, 1953, the taxpayer filed a petition with the Tax Court for redetermination of the deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 18-28.) The decision of the Tax Court in favor of the Commissioner was entered on April 3, 1957. (R. 296.) The case is brought to this Court by a petition for review filed July 1, 1957. (R. 303-304.)

Tax Court Docket No. 51526. Notice of deficiencies was mailed to the taxpayer E. Royce and Dora F. Royce in the total amount of $109,112.16 for the taxable years 1948 and 1949. (R. 40-56.) On December 21, 1953, the taxpayers filed a petition with the Tax Court for redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 30-56.) The decision of the Tax Court that there were deficiencies in the total amount of $44,645.02 was entered on April 3, 1957. (R. 297.) The case is brought to this Court by a petition for review filed July 1, 1957. (R. 304-305.)

Tax Court Docket No. 51527. Notice of deficiencies was mailed to the taxpayer Ezra Royce in the total amount of $825,924.47 and $94,609.68 penalties for the taxable years 1944, 1945, 1946 and 1947. (R. 76-103.) On December 21, 1953, the taxpayer filed a petition for redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 59-103.) The decision of the Tax

Court that there were deficiencies in the total amount of $528,697.45 and $4,882.58 penalty was entered on April 3, 1957. (R. 298). The case is brought to this Court by a petition for review filed July 1, 1957. (R. 305-307.)

Tax Court Docket No. 51528. Notice of deficiencies was mailed to the taxpayer B. Royce in the total amount of $28,820.62 and $2,005.84 penalty for the taxable years 1945 and 1947. (R. 124-145.) On December 21, 1953, the taxpayer filed a petition for redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 114-145.) The decision of the Tax Court that there were deficiencies in the total amount of $22,847.30 was entered on April 3, 1957. (R. 299.) The case is brought to this Court by a petition for review filed July 1, 1957. (R. 307-308.)

Tax Court Docket No. 51529. Notice of deficiencies was mailed to B. Royce, executor of the estate of Isabelle H. Royce, deceased, in the total amount of $51,770.38 and $2,588.89 penalty for the taxable years 1945, 1946 and 1947. (R. 159-176.) On December 21, 1953, the executor filed a petition for redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 149-176.) The decision of the Tax Court that there were deficiencies in the total amount of $44,134.78 was entered on April 3, 1957. (R. 300.) The case is brought to this Court by a petition for review filed July 1, 1957. (R. 308-309.)

Tax Court Docket No. 51531. Notice of a deficiency was mailed to the taxpayers Robert T. Jacob and

Agnes C. Jacob in the total amount of $66,977.56 and $4,035.66 penalty for the taxable year 1945. (R. 185-191.) On December 21, 1953, the taxpayers filed a petition for redetermination of the deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 179-191.) The decision of the Tax Court in favor of the Commissioner was entered on April 3, 1957. (R. 301.) The case is brought to this Court by a petition for review filed July 1, 1957. (R. 309-310.)

Tax Court Docket No. 51533. Notice of deficiencies was mailed to the taxpayers Albert L. Schneider and Bertha Schneider in the total amount of $24,228.55 and $1,102.38 penalty for the taxable years 1945, 1948 and 1949. (R. 198-207.) On December 21, 1953, the taxpayers filed a petition for redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 193-207.) The decision of the Tax Court that there were deficiencies in the total amount of $23,-450.97 and $1,102.38 penalty was entered on April 3, 1957. (R. 302.) The case is brought to this Court by a petition for review filed July 1, 1957. (R. 310-311.)

Jurisdiction over each of the above actions is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether the Tax Court erred in holding that the disbursement of earnings by Oregon Motor Stages in 1945 in payment of the ABC note and the simultaneous redemption of the 350 shares of stock purchased

with the proceeds of such note, together with the disbursements for incidental expenses charged by ABC for making the loan, constituted distributions essentially equivalent to dividends under Section 115(g) of the Internal Revenue Code of 1939 and were therefore taxable to the stockholders.

2. Whether the Tax Court erred in holding that the disbursement by Hippodrome Amusement Company in 1945 was a dividend and not a loan to the taxpayer, E. Royce, and was therefore taxable to him.

3. Whether the Tax Court erred in holding that Dora Royce was not a bona fide member of the Portland and Seattle partnerships and that Eunice (or her trust) was not a bona fide member of the Seattle partnership.

STATUTES AND REGULATIONS INVOLVED

The pertinent portions of the statutes and Regulations involved are set forth in the appendix, *infra*.

STATEMENT

This case involves several consolidated proceedings. After trial based upon considerable oral testimony and stipulations of the parties the Tax Court entered a memorandum opinion. The findings of fact contained therein are as follows:

1945 disbursements by Oregon Motor Stages from surplus account

The Oregon Motor Stages (hereinafter called Stages) was organized as an Oregon corporation in 1931, and in 1945 was the largest intrastate bus company operating in Oregon. Stages operated its

motor busses as a public carrier pursuant to a permanent franchise under the rules and regulations of the Interstate Commerce Commission. In June, 1945, the issued and outstanding capital stock of Stages consisted of 750 shares of common stock. (R. 221.)

During April or May, 1945, Schneider, after contacting the stockholders of Stages, advised E. Royce that all the stock of the corporation was for sale. Promptly thereafter, E. Royce and Jacob entered into discussions with various individuals and the stockholders in regard to the purchase of the stock based upon a price of $1,000 per share. As a result of the negotiations, they and B. Royce, Niederkrome and Jacob expressed a willingness to purchase a total of 400 shares. Negotiations were conducted with other individuals concerning the purchase of the remaining 350 shares of the stock but they declined to participate in the venture. In addition, consideration of giving Stages an option to purchase the 350 was developed to the point of drafting an agreement for that purpose. (R. 222.)

During the middle or latter part of June, 1945, L. R. Bentson visited Portland and was consulted about the venture. Bentson, born in 1869, was an American citizen and resided in Canada after 1906. He was an uncle of E. Royce, B. Royce and Fannie Orsen, whom he visited about once a year during a stay of four or five days in Portland. He was not a man of expensive habits or a lavish spender and lived modestly with his wife in a small house in Vancouver, D. C., which was valued at $4,200 at the time of his death in April, 1950. He left an estate

of $33,673.06 to Fannie Orsen. He owned a house and garage in Vancouver, which he rented in 1945 for $20 and $12 per month, respectively. Bentson invested small amounts of money in Canadian securities and made regular small deposits to his bank account, which, on August 14, 1945, aggregated $6,539.42. What funds he had were said to be blocked by wartime restrictions in Canada. (R. 222-223.)

Prior to June 20, 1945, application for loan of $350,000 was made by E. Royce to American Business Credit Corporation, an Oregon corporation doing business in Portland, Oregon (hereinafter called ABC-Portland). The application was duly submitted to the parent company, American Business Credit Corporation (hereinafter referred to as ABC-Delaware), a Delaware corporation, at its offices in New York City, for approval.[1] (R. 223.) The application for loan of $35,000 was considered by the Executive Committee of the parent company on June 20, 1945, the pertinent portion of the minutes of which committee reads as follows (R. 223-224):

> Mr. Davidson and Mr. Ebe then submitted an application on behalf of ABC-Portland. A group of outstanding individuals in Portland, headed by Messrs. Barney & Roy Royce and Robert Jacob, desire to purchase the entire capital stock of Oregon Motor Stages, largest intra-state bus company operating in Oregon. Capital stock consists in all of 750 shares Common, par value $100.00 per share, book value $537.00 per share.

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[1] ABC-Portland was dissolved or abandoned about 1949 and its records transferred to the main office of the parent company in New York.

The stock is to be acquired for a price of $750,000. The purchasers intend to buy 400 shares for $400,000, with their own funds. They ask that we extend a line of credit of $350,000, the balance of the purchase price of the Oregon Motor Stages stock. We are asked to lend Mr. Roy Royce, personally, the sum of $350,000, on his note, to be secured by all of the capital stock of Oregon Motor Stages. Our loan to be repaid in 90 days or adjusted as conditions warrant. Mr. R. Royce's personal statement reflects a net worth of $1,366,000.00. Retiring stockholders will guarantee to R. Royce and his associates that the worth of Oregon Motor Stages is not less than the figure shown on the company's 4/30/45 statement. A fee of $5,000 plus 5% per annum on cash for every 90 days is charge contemplated.

The Committee reviewed in detail the financial condition of Oregon Motor Stages as of 12/30/44 and 4/30/45 and its operating results for 1944. Mr. Davidson was questioned in respect to the proposed transaction and Mr. Dick's opinion was received. After consideration and full review, the Committee unanimously approved the credit line requested, subject to approval of counsel, and the sollowing [sic] stipulations:

1. Subject to unanimous approval of full Portland Committee.

The sale and puhchase of the 750 shares of capital stock of Stages was consummated on July 2, 1945, at which time the former shareholders transferred 750 shares of stock in such manner that each of the taxpayers named and L. R. Bentson received certificates for the number of shares indicated (R. 224-225):

Niederkrome	55
E. Royce	145
B. Royce	50
Robert T. Jacob	100
A. L. Schneider	50
L. R. Bentson	350
Total	750

All of these certificates of stock were immediately endorsed in blank and turned over to a representative of ABC to secure the loan from that company of $350,000, Bentson giving his receipt to each of the others for their respective stock certificates, "such stock being loaned to me to be pledged to American Business Credit Corporation as collateral to loan this day made to me for the purchase of Three Hundred Fifty (350) shares of the common capital stock of said company." On the same date, July 2, 1945, ABC issued its check for $350,000 payable to L. R. Bentson and E. Royce. (R. 225.) The payees in turn executed a note dated July 2, 1945, in the amount of $350,000, secured by all of the capital stock of Stages, and reading as follows (R. 225-227):

$350,000.00 Portland, Oregon, July 2, 1945.

On or before ninety (90) days after date, for value received, we, jointly and severally, promise to pay to the order of AMERICAN BUSINESS CREDIT CORPORATION Three Hundred Fifty Thousand and no/100 ($350,000.00) Dollars, with interest from date hereof, payable monthly on the first day of each month thereafter, at the rate of 5 per cent per annum. Principal and interest payable in lawful money of the United States of America at the office of American Business Credit Corpora-

tion, Pacific Building, Portland, Oregon; and as collateral security for the payment of this note we, jointly and severally, herewith deposit and pledge with said American Business Credit Corporation 750 shares of the capital stock of Oregon Motor Stages, an Oregon corporation, evidenced by the following certificates: certificate 72 for 145 shares; certificate 73 for 100 shares; certificate 74 for 55 shares; certificate 75 for 50 shares; certificate 76 for 50 shares and certificate 77 for 350 shares; and we, jointly and severally, empower said American Business Credit Corporation, with option as to time and manner, to collect or sell and deliver all or any part of said capital stock and the certificates evidencing the same, with or without notice to us, or either of us, and to apply the proceeds thereof to the payment of this note with all interest due thereon, and to the payment of all expenses attending the sale or protesting of the said collateral; and in case the proceeds of the sale of said collateral shall not cover the principal, interest and expenses we, jointly and severally, promise to pay the deficiency forthwith after such sale; and in case suit or action is commenced to collect this note or any portion thereof, we, jointly and severally, promise to pay such additional sum as the court may adjudge reasonable as attorney's fees in any such suit or action.

/s/ L. R. BENTSON
/s/ E. ROYCE

On July 17, 1945, George W. Davidson, manager of ABC-Portland, billed Stages for $4,315.07, an amount which represented the ABC servicing fee for

financing the loan. The invoice was okayed by E. Royce and on July 19, 1945, Stages issued its check in full payment. The payment was charged to an expense account on the books of Stages. (R. 227.)

Two months later, on or about August 31, 1945, Stages received a letter dated August 31, 1945, signed by L. R. Bentson, reading as follows (R. 227-229):

Vancouver, B. C.
August 31, 1945

Oregon Motor Stages,
Portland
Oregon

Gentlemen:

I hereby offer to sell to Oregon Motor Stages my Three Hundred Fifty (350) shares of stock in the Company for cash at the price of One Thousand Dollars ($1,000.00) per share, total price Three Hundred Fifty Thousand Dollars ($350,000.00). You are to have thirty days in which to close the transaction, but it is understood between us that you will make every reasonable effort to do so within a lesser time.

I represent and warrant that my 350 shares of stock are free and clear of encumbrances, save and except for a note in the sum of $350,000.00 payable to the American Business Credit Corporation and the transfer will be made upon the sole condition that your Company assume and pay the amount of interest that is due and owing from me to said corporation on account of this note.

My object in desiring to dispose of this stock is that the sudden end of the war has made a great difference in my plans, and on this account I de-

sire to be relieved of my obligation to the said American Business Credit Corporation.

Very truly yours,

/s/ L. R. BENTSON
August 31, 1945.

The above offer is hereby accepted.
OREGON MOTOR STAGES

By /s/ E. ROYCE,
President.

A joint and special meeting of the stockholders and directors of Stages was held on September 5, 1945, at which time such letter was considered. Bentson was one of the stockholders present at the meeting, the minutes of which meeting read in part as follows (R. 229-231):

> The President, E. Royce, presided and Secretary Robert T. Jacob kept a record of the proceedings.
>
> Consideration was then given to the written offer of stockholder, L. R. Bentson, dated April 31, 1945, copy of which is attached to these minutes.
>
> The president then canvassed each and every stockholder present, either in person or by proxy, and each and every share of stock present, either in person or by proxy, except the 350 shares owned by stockholder, L. R. Bentson, expressly waived the right to sell their shares to the corporation.
>
> Thereupon consideration was given to the applicable Oregon statutes and the balance sheet of

the Company as at August 31, 1945 which the President submitted to the meeting was inspected, and thereupon the following resolutions were adopted by the unanimous vote of 400 shares of stock of the Company, stockholder L. R. Bentson, at his request, being excused from voting:

WHEREAS, express power is given in the Articles of Incorporation of this Company to purchase its own stock; and

WHEREAS, this Company has a surplus substantially exceeding $350,000.00, and it is to the best interests of the Company to use $350,000.00 of such surplus to retire 350 shares of its issued and outstanding capital stock at a price of $1,000.00 per share and to use $350,000.00 of such surplus for such purpose; and

WHEREAS, such purchase may be made without injury to the existing creditors and all of the stockholders of the Company, except stockholder L. R. Bentson, have waived their priority and have consented that the 350 shares belonging to L. R. Bentson shall be so purchased and retired; and

WHEREAS, said stock so purchased should be cancelled and the capital stock of the Company reduced in the amount of $35,000.00, Now, Therefore,

BE IT RESOLVED: That this Company shall purchase and retire 350 shares of stock belonging to L. R. Bentson at the price of $1,000.00 per share out of its surplus, and that the stock so purchased shall be cancelled; and

FURTHER RESOLVED: That the capital stock of this Company be reduced from $75,000.00, divided into 750 shares of the par value of $100.00 each, to $40,000.00 divided into 400 shares at the

> par value of $100.00 each, and that the Secretary be and he is hereby instructed and directed to file with the Corporation Commissioner of Oregon an appropriate certificate and affidavit of such reduction in capital stock, as required by law.

On September 6, 1945, Stages purchased and retired the 350 shares of capital stock, and on the same date issued its check in the amount of $350,000, payable to L. R. Bentson. The check was endorsed by Bentson and delivered to ABC-Portland in payment of the loan. The payment of $350,000 was recorded on the books of Stages as a debit to surplus of $315,000 and a debit to capital stock of $35,000.[2] On September 17, 1945, Stages issued its check in the amount of $3,739.73 to ABC-Portland, for interest due and owing on the loan of $350,000. This payment was charged to interest expense on the books of Stages. (R. 231.)

Bentson did his own bookkeeping. In his day book Bentson listed in detail items of income and expense, and purchase and sale of securities. It contained numerous entries on stocks purchased and sold by him during the ensuing years, including the year 1945. It did not contain any entries reflecting the purchase or sale of Stages stock in 1945. (R. 231.)

Bentson was neither an officer nor a director of Stages, and he did not participate in the operation of

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[2] On April 2, 1946, the Corporation Commissioner of the State of Oregon issued to the corporation its certificate of decrease in the capital stock of the corporation from an authorized capital stock of $75,000 to an authorized capital stock of $40,000. (R. 231.)

the corporation. Schneider was general manager, vice president and director, and the only one who was actually active in the company's affairs. Jacob was secretary and director. E. Royce was president and director. Niederkrome was treasurer and director. E. Royce, Jacob and B. Royce paid for their Stages stock out of their own funds. Schneider paid for his 50 shares with his own money, although E. Royce advanced him $50,000 for the purpose for a few days. E. Royce advanced Niederkrome $55,000 for his 55 shares, and Niederkrome gave him a note for $55,000. On June 20, 1946, Niederkrome transferred his 55 shares to Schneider at the same price. Schneider paid several thousand dollars on account of the stock and gave a note to E. Royce for the balance. Niederkrome's unpaid note to E. Royce was cancelled, and Schneider's note remained unpaid until the subsequent liquidation of Stages, when a compensatory offset was made against it as among the stockholders. (R. 231-232.)

During the Commissioner's investigation, Niederkrome confided to the revenue agents that he thought the corporation had obtained the loan from ABC. When the stock in the name of Bentson was offered for sale to Stages on August 31, 1945, no serious effort was made to interest other purchasers in buying the stock. The availability of the stock for sale in September of 1945 was communicated by Schneider to one of the individuals formerly interested in buying it and Schneider was informed by this individual that he was no longer interested. (R. 232.)

Stages was in good financial condition in 1945 and had a very fine earning record. It had paid substantial dividends in the years prior to 1945. Although its bus equipment was becoming somewhat worn, due to the wartime conditions, it had a large reserve available for the purchase of additional equipment; it was doing an excelent business; its gross earnings were in excess of $1,000,000 per year, and in two years were in excess of $2,000,000. The taxpayers were optimistic about the post-war future of Stages. It was their opinion that the company would prosper after the war, despite an expected decline in revenues as a result of the loss of military business. They thought that wage rates would be reduced, and the population of Oregon doubled, within the next ten years. They regarded Stages as a very profitable venture, one which presented an excellent opportunity for a good, solid bus operation. Stages had an earned surplus in excess of $350,000 at the time of the stock redemption on September 6, 1945. (R. 233.)

There was no diminution of or curtailment in the corporate activity and business of Stages as a result of the stock redemption. The corporation continued to operate under its permanent franchise under the Interstate Commerce Commission, and it continued to serve the people who desired to use its facilities. (R. 234.)

In 1945, Stages expended cash and incurred a long-term obligation of $90,000 for the purchase of new bus equipment costing $179,940.71, of which cost $155,945.71 was expended prior to taxpayers' and Bentson's acquisition of Stages stock. In 1945, also,

depreciation on Stages' equipment amounted to $119,564.23, and busses costing $74,404.12, having a depreciated basis of $3,877.87, were sold for a net profit of $18,903.83. In 1946, Stages purchased new bus equipment costing $183,009.33, and increased its long-term obligations to $155,000. Depreciation on Stages' equipment in 1946 amounted to $124,673.58, and busses costing $148,951.47, and having a depreciated basis of $700, were sold for a net profit of $44,565.81. During 1947, Stages acquired new bus equipment costing $147,862.99 and a new building costing $103,390.33; it increased its long-term obligations (equipment) to $184,934.91; and it incurred a new long-term obligation (building) of $71,000. Depreciation on Stages' equipment in 1947 amounted to $138,637.85 and busses costing $56,722.11, and having a cost basis of $450, were sold for a profit of $9,990.24. (R. 234-235.)

The gross revenues and cumulative undivided profits of Stages for the years 1945 to 1948, inclusive, were as follows (R. 235):

Year	Revenues	Cumulative Undivided Profits at End of Year
1945	$2,387,331.82	$102,469.34
1946	1,802,712.13	202,356.07
1947	2,072,584.49	236,983.53
1948	1,756,559.03	218,500.09

Stages did not declare or pay dividends to its stockholders in 1945 and 1946, or in any other year under the operation of the taxpayers. The taxable net income of Stages for 1945 and 1946 was $426,885.28

and $153,318.31, respectively. In answer to Question No. 8 on the income tax return of Stages for the year 1946 concerning the retention of over seventy per cent of the earnings and profits, the following reason was given (R. 235):

> Company is replacing equipment badly worn through the war use and is buying other equipment to better service. Needs all funds for further expansion.

The Tax Court found that the record failed to overcome the determination of the Commissioner that Bentson was not a bona fide participant in the transactions leading up to the acquisition of Stages stock and was not a bona fide stockholder in Stages at all times material. It was further found that the Commissioner's determination that the corporate distributions by Stages, in retirement of the 350 shares of its stock issued in the name of Bentson and in payment of certain incidental expenses, were made at a time or under such circumstances as to be essentially equivalent to dividends taxable to Niederkrome, E. Royce, B. Royce and wife, Jacob and wife, and Schneider and wife is not overcome by the evidence of record. (R. 236.) From these determinations the taxpayers here petition for review.

The disbursement by Hippodrome

The Hippodrome Amusement Company was an Oregon corporation engaged in the business of renting property at Seaside, Oregon. It owned two pieces of property in the center of the city, one improved, the

other unimproved. Most of the improved property was devoted to rental purposes, and the balance, in 1945, was used as a dance hall. (R. 257-258.) In 1945, the issued and outstanding stock of the corporation was owned as follows (R. 258):

E. Royce	218	shares
B. Royce	111	"
Niederkrome	19	"
Stephen Bartle	5	"
Total	353	"

The first three persons above listed were directors. E. Royce, the only taxpayer concerned in this issue, was president and Niederkrome secretary and auditor of the corporation. The latter worked under the former and, to a considerable extent, followed his instructions and orders. (R. 258.)

On December 28, 1945, Hippodrome issued a check payable to E. Royce in the amount of $20,000. This payment was recorded on the corporate books by debiting an account receivable, entitled "Due from Stockholders," and crediting the cash account. The disbursement of $20,000 to E. Royce was made with the consent and agreement of B. Royce and Niederkrome. There were no minutes of the corporation authorizing such payment. E. Royce executed no note or other evidence of indebtedness, he paid no interest at any time, and to the time of the hearing had made no repayment. E. Royce has at all times been financially able to repay the amount withdrawn by him. His personal financial statement in 1945 reflected a net worth of $1,366,000. He had large investments in

many business enterprises. In 1945, E. Royce loaned Niederkrome $55,000, advanced Schneider $50,000, and invested $145,000 in stock of Stages. Later he financed the development of a gold mine called Alder Gold-Copper Company, promoted the sale of its stock, and obligated himself to supply the company with $250,000. In 1945, he reported a net income of $122,951.95, which included earnings of $113,530.63 from five partnerships, namely, Yellow Cab Company of Seattle, Gray Line Motor Tours of Seattle, Yellow Cab Company of Portland, Royce Brothers of Portland, and Queen City Garage of Seattle. (R. 258-259.)

In 1948, Hippodrome disbursed $400 to Niederkrome which was also charged to the account receivable entitled "Due from Stockholders." Similarly, as in the case of E. Royce, there were no corporate minutes authorizing the payment; he executed no note or other evidence of indebtedness; he paid no interest at any time; and there has been no repayment. (R. 259.)

On April 1, 1954, Niederkrome opened new accounts on the books of Hippodrome entitled "Notes Receivable—E. Royce" and "Notes Receivable—F. C. Niederkrome," to which he debited $20,000 and $400, respectively, at the same time crediting the "Due from Stockholders" account with $20,400, thus closing out such account. (R. 259-260.)

Hippodrome operated at a loss before the war and carried a deficit for about ten years during the 1930's. In the early years it was necessary for E. Royce and B. Royce to advance moneys to the company at times

to help it out. The financial and operating condition of the company improved thereafter and, in the years before 1945, an earned surplus was built up, and funds were accumulated. The company continued to prosper in 1945 and the years subsequent thereto, and is presently a company in good financial standing with a book net worth of $70,000, the fair value of which is probably $140,000. Hippodrome operated on the basis of a fiscal year ending March 31. On March 31, 1945, the earned surplus was $16,576.34. It had earnings of $5,127.06 from operations during the year ended March 31, 1946. The earned surplus on March 31, 1946, was $21,703.40. There was no formal declaration of dividends by Hippodrome in December, 1945. (R. 260.)

Hippodrome Amusement Company had no building program or plans for immediate expansion in 1945. Its plans for the remodeling of its buildings, or for the construction of a building on the vacant portion of its property, were not conceived or developed until 1948 or 1949. (R. 260.)

The Tax Court found that the withdrawal of $20,000 by E. Royce in 1945 was not a loan to him by Hippodrome, but was a distribution out of the profits taxable to him as a dividend. (R. 261.)

Yellow Cab "Partnerships"—E. Royce and Dora Royce

Prior to August 1, 1942, Yellow Cab Incorporated was an Oregon corporation engaged in the operation of a taxicab business in Portland, Oregon. On August 1, 1942, the corporation was liquidated and dissolved. On the same date, a partnership under the name of

Yellow Cab Company (hereinafter called Portland partnership) was formed to operate the business formerly conducted by the corporation. On July 31, 1942, immediately prior to the dissolution of the corporation, E. Royce transferred 14,000 shares of the corporate stock to his wife, Dora F. Royce. This transfer represented slightly less than half of the shares of stock formerly held by him. The transfer of the stock to Dora was made in anticipation of the planned dissolution of the corporation and the simultaneous formation of the partnership, and the purpose of the transfer was to qualify Dora for admission to the partnership. (R. 263.)

The Portland partnership agreement provided that the interests of the respective parties would be as follows (R. 265):

E. Royce	26.1575%
B. Royce	26.1575%
Charles W. Keffer	.659 %
C. H. Luton	.906 %
Dora F. Royce	23.06 %
Isabelle H. Royce	23.06 %

Profits and losses were to be borne in the proportion of the above interests. Each of the parties was to have an equal voice in the control and operation of the business. (R. 265.)

Luton and Keffer were employees, and their small partnership interests were purchased by E. Royce and B. Royce on November 28, 1942. (R. 266.)

Prior to April 20, 1944, Yellow Cab Company of Seattle was a Washington corporation engaged in the operation of a taxicab business in Seattle, Washing-

ton. The issued and outstanding shares of stock of the corporation were owned as follows (R. 266):

W. L. Rothschild	607½
J. A. Baldi	606
Geo. E. Worster	606
D. N. Newton	606
E. Royce	1,402½
B. Royce	1,402½
A. H. Wenck	269
Total Shares	5,500

On May 1, 1944, the Yellow Cab Company was liquidated and dissolved. On the same date, May 1, 1944, a partnership of the same name (hereinafter called Seattle partnership) was formed to operate the business formerly conducted by the corporation. (R. 266-267.)

On April 20, 1944, immediately prior to the disolution of the Seattle corporation, E. Royce transferred 402½ shares of the corporate stock to his wife, Dora F. Royce. At the same time he transferred 700 shares of the stock to himself as trustee for his minor daughter, Eunice Royce, then fourteen or fifteen years of age. He retained 300 shares of stock for himself. On the same date, April 20, 1944, E. Royce executed a declaration of trust by which he declared himself trustee of the 700 share of stock in trust for Eunice Royce. The transfers of the stock to Dora F. Royce, and to himself as trustee for Eunice Royce, were made in anticipation of the planned dissolution of the corporation and the simultaneous formation of the partnership, and the purpose of the transfers of stock was to qualify Dora and the trust for admission to the

partnership. Gift tax returns were filed covering the gifts of stock in the Seattle corporation to both Dora and the trust. (R. 267.)

The Seattle partnership agreement provided that salaries and distribution of the profits were to be made as follows (R. 269-270):

Salaries: A. H. Wenck, a monthly salary to be determined by partners

B. Royce and E. Royce, 2½% of net profits, but not exceeding $5,000 per annum

Profits:

B. Royce	1402½/5500th
E. Royce	300 / 5500ths
E. Royce, Trustee for Eunice M. Royce	700 / 5500ths
Dora Royce	402½/5500ths
A. H. Wenck	269½/5500ths
W. L. Rothschild	485½/5500ths
J. A. Baldi	485 / 5500ths
G. E. Worster	485 / 5500ths
D. N. Newton	485 / 5500ths
L. S. Ackerman	485 / 5500ths

Any losses were to be borne in the same proportion as the profit distribution. (R. 269-270.) Decisions on partnership matters were to be made by a majority in interest of the partners. (R. 269.)

The Portland partnership and the Seattle partnership kept their books and prepared their tax returns on an accrual basis of accounting during all the years in question. E. Royce was the most active partner in the Portland partnership. He made the important decisions as well as the day-to-day decisions involved in the operation of the business. He was in charge of

the office, and his supervision and management included the shop and garage personnel. B. Royce was relatively inactive. Niederkrome was accountant for the Portland partnership. Dora devoted some time to checking the drivers and cars at the stands, boats, depots and any place in Portland where the cabs came frequently to pick up or discharge passengers. She also checked the appearance and condition of uniforms, cleanliness, number of passengers carried and made written reports on these matters to the office. On Schedule I of the partnership returns filed by the Portland partnership for the years 1946 through 1949, no percentage of time devoted to the business by Dora is indicated. Duties similar to those rendered by Dora for the Portland partnership were rendered by an employee of the Seattle partnership for that firm. (R. 271-272.)

The drawing accounts of Dora and E. Royce on the books of the Portland partnership show withdrawals during the taxable years 1944 through 1947, as follows (R. 272):

Year	Dora F. Royce	E. Royce
1944	$ 48,777.75	$ 58,184.94
1945	69,180.00	80,820.00
1946	48,865.01	57,086.99
1947	4,612.00	5,388.00
Total	$171,434.76	$201,479.93

The withdrawals of both from the Seattle partnership during the years 1945 through 1949 were as follows (R. 272-273):

Year	Dora F. Royce	E. Royce
1945	$41,622.53	$30,994.97
1946	19,662.53	14,644.97
1947	12,342.53	9,194.97
1948	12,342.53	9,194.97
1949	5,022.53	3,744.97
Total	$90,992.65	$67,774.85

At the end of 1947, the Portland partnership's accumulated earnings distributable to Dora exceeded her withdrawals by $35,434.76, and those distributable to E. Royce exceeded his withdrawals by $38,395.26. At the end of 1949, the Seattle partnership's accumulated earnings distributable to Dora and E. Royce exceeded their withdrawals by the amounts of $18,733.16 and $14,008.75, respectively. (R. 273.)

The foregoing withdrawals by Dora were in the form of checks made payable to her. Checks so issued to her by the Portland partnership in 1944, in the aggregate amount of $48,777.75, were endorsed in blank. Another check so issued to her by the Portland partnership on February 23, 1945, in the amount of $11,530, was also endorsed in blank by Dora and paid by the drawee, the United States National Bank, on April 3, 1945. All other checks issued to Dora by the Portland partnership and all those issued to her by the Seattle partnership, totaling $170,479.59, were endorsed in blank both by her and by E. Royce. (R. 273.)

During the year 1944 and through July of 1945, Dora maintained a checking account at the Sixth and Morrison Branch of The First National Bank of

Portland in the name of "Mrs. E. Royce." Beginning with August, 1945, the account was in the name of "Dora F. Royce." (R. 273-274.) The deposits to and withdrawals from this account for the years 1944 through 1947 were as follows (R. 274):

Year	Deposits	Withdrawals
1944	$ 21,386.75	$ 22,507.83
1945	38,712.25	36,114.11
1946	73,491.78	71,563.02
1947	46,485.00	50,106.19
Total	$180,075.78	$180,291.15

The foregoing deposits represented some of the distribution checks above mentioned. Dora also had occasion to use a safe deposit box during each of the taxable years, into which were placed various amounts of cash derived from such distributions. The balance in the account on January 1, 1944, was $2,242.57 and on December 31, 1947, $2,648.91. (R. 274.)

A substantial portion of the partnership earnings distributed to Dora by both partnerships was expended in payment of state and federal taxes. The amounts so expended by Dora for federal taxes for the years 1944 to 1947 were as follows (R. 274):

Year	Amount
1944	$ 29,793.72
1945	57,315.46
1946	51,721.22
1947	29,454.14
Total	$168,284.54

Dora filed joint returns with E. Royce for 1948 and 1949, and taxes were paid in the amounts of

$28,230.87 and $17,522.44, respectively, or a total of $45,753.31. (R. 275.)

A portion of the distributions made to Dora by both partnerships was expended by her for such items as (R. 275):

Item	Approximate Cost
2 Fur Coats	$1,850
2 Chrysler Autos	8,000
Plymouth and Cadillac	Unknown
Exercycle	350
Silverware	1,800
Lace Cloth	400
Government Bonds	7,000
Missouri-Pacific Stock	2,500
House Improvements	18,000

In addition to the above amounts, a total of approximately $70,000 was loaned to E. Royce to be invested in Alder Gold-Copper Company, a company in which, in 1947 and years subsequent thereto, E. Royce was interested. Other amounts were given to E. Royce to reimburse him for payments he had made for Dora. (R. 275.)

After trial, the Tax Court held that Dora F. Royce was not a bona fide member of the Portland and Seattle partnerships during the taxable years for income tax purposes and that the Commissioner had properly included in the income of E. Royce the partnership profits reported by her. (R. 275.)

Seattle Partnership—Trust for Eunice Royce

On April 20, 1944, E. Royce executed a declaration of trust in favor of his daughter Eunice with respect

to 700 shares of common stock of the Yellow Cab Company of Seattle. (R. 278.)

The purpose, terms and conditions of the trust provided in part as follows (R. 278-282):

> (1) To collect the net income therefrom and to pay the same over to my said daughter, or to accumulate the same for her use and benefit, and invest and reinvest the same as hereinafter provided for principal of the trust estate, and as her absolute and separate property for and during the term of her natural life, or until this trust is sooner terminated by my death or otherwise, as hereinafter provided for.
>
> (2) I, as such trustee hereunder, am to have and there is hereby reserved to and vested in me full discretionary power and authority to sell or exchange from time to time, all of the aforesaid property or any part thereof, or any other property belonging to this trust, and to buy any other property upon such terms, for such price, or for such property as in my discretion I shall see fit; and the proceeds so received upon such sale or exchange shall be invested or reinvested in such securities or other properties as I may deem advisable, all of same to be held upon the same trusts as are hereinabove and hereinafter declared.
>
> (3) In the event that it shall appear to me at any time or times that the personal or family necessities of my said daughter require a payment or payments of money to her, then in my sole discretion, I may pay over to her, and there is hereby reserved to me the power and authority to pay over to her, such portion of the corpus of the said trust estate as I may deem necessary or

proper; without first applying any net income or accumulated net income therefor, and in such event, any such payments may be treated by me, at my election, as trustee, as if an absolute gift had been made herein of such corpus or portions thereof to my said daughter, or as a loan to be repaid to the trust estate by her, either from future income or otherwise.

(4) This Trust shall be irrevocable, with no power reserved to alter, amend, cancel, revoke or terminate the same, except as may otherwise herein be provided.

* * * *

(6) I, alone, hereby reserve the right and power, during my lifetime to nominate and appoint a successor trustee, to carry out the provisions of this trust, in my place and stead, such appointment to take effect either during my lifetime or at my death, as I may direct, by the execution of a formal document designating such successor trustee, but the exercise of such power shall not exhaust the power or extend the term of the Trust. Any such appointment shall be completed upon the turning over and delivery to such successor trustee of the Trust property and estate.

(7) Should I at any time become incapacitated to administer this trust, or upon my death, in default of the appointment of another trustee by me, my wife, DORA F. ROYCE, my brother, B. ROYCE and A. L. SCHNEIDER shall act as co-trustees in my place and stead, each of said co-trustees to have an equal voice in the management of said estate, and such successor trustees are hereby directed to pay to my said daughter monthly or quarterly during her lifetime, begin-

ning with the date of my death, so much of the net income of the trust estate after paying costs and charges as may be necessary to meet the schooling, living and other needs and desires of my said daughter as she may direct.

In the event the annual income from the trust estate in any year, before or after my death, shall fall below $2,000.00, and it shall appear to the trustee or trustees that the personal or family needs of my said daughter shall require a payment or payments or money in addition to the income from the trust property, the trustee or trustees in his or their discretion may pay over to my said daughter, and it is hereby reserved to such trustee or trustees the power and authority to pay over to her, such portion of the principal of the trust estate as may be necessary to pay to my said daughter sums which shall aggregate, at least, the sum of $2,000.00. This provision is not intended to limit the payments to my said daughter, but to enlarge the powers otherwise granted in this instrument.

(8) Before making any investment, change of investment, or sale of any property or securities in the trust fund, the trustee or trustees who succeed me and their successors shall consult and advise with my said daughter, EUNICE M. ROYCE, and, if the said EUNICE M. ROYCE shall fail to indicate her disapproval of any proposed investment, change of investment, or sale, within fifteen (15) days after notice thereof, the trustees, if they deem the same advisable, may make such investment, change of investment or sale, without such approval.

(9) Upon my said daughter reaching the age of thirty-five (35) years, if, in the judgment of

> the trustee or trustees then living, my said daughter desires to receive the corpus of the trust estate and she is considered by the said trustee or trustees to be capable of managing the trust estate wisely, then, and upon the concurrence of these two events, the trustee or trustees shall convey the corpus of this trust to my said daughter in her absolute right. If, in the judgment of the trustee or trustees my said daughter is not capable of managing the trust estate wisely when she reaches the age of thirty-five (35) years, then as soon thereafter as she convinces the trustee or trustees of her ability to manage said estate wisely, said trust property shall be conveyed to her absolutely.
>
> * * * *

E. Royce never regarded the Declaration of Trust as a real trust, nor did he treat it as such during the ensuing years. He did not file fiduciary income tax returns for the trust. He made no accounting to Eunice, nor has he ever reported to her in respect to the status of the trust. He filed income tax returns in the name of Eunice M. Royce for the years 1944 and 1946 to 1949, inclusive. He signed her name "Eunice May Royce," or "E. M. Royce, by E. Royce, Trustee," on the returns. He so filed an unsigned Form 1040 for 1945. Eunice became eighteen years old in 1947. She lived at home until then. From 1947 to 1951 she went to the University of Oregon. From March, 1952, to March, 1954, Eunice worked for the Imperial Travel Bureau. She was married June 12, 1954. She is now Eunice Dodge and resides at Wenatchee, Washington. At the time of the hearing she was

twenty-six years of age. Eunice was first told about the trust in 1947 when she was eighteen years of age. (R. 282.)

During the years in question, substantially the only income reported on the returns filed in the name of Eunice Royce represented those earnings of the partnership distributable to "E. Royce, trustee for E. M. Royce," as follows (R. 283):

Year	Amount
1945	$47,797.11
1946	54,826.23
1947	47,645.90
1948	20,863.27
1949	16,611.08

The drawing account of "E. Royce, trustee for E. M. Royce," on the books of the Seattle partnership disclosed withdrawals aggregating $205,154.94 during the period from January 1, 1944, to December 31, 1949, as follows (R. 283):

Year	Amount
1944	$ 16,422.49
1945	77,422.49
1946	46,922.49
1947	34,192.49
1948	21,462.49
1949	8,732.49
Total	$205,154.94

On December 31, 1949, the earnings distributable to "E. Royce, trustee for E. M. Royce," exceeded the withdrawals by $32,592.59. The excess amount had been retained in the business and not withdrawn. (R. 283.)

The foregoing withdrawals were deposited by E. Royce in a trust account at the United States National Bank. E. Royce, alone, was authorized to sign checks on this account. He has exercised absolute discretionary power and authority over the funds and, excepting for certain small amounts, Eunice has never received anything from the trust. The checks issued by E. Royce on the trust account during the period from January 1, 1944, to December 31, 1949, aggregated $186,046.21, leaving a balance in the account of $19,108.73. (R. 283-284.) These funds were directed to the following purposes (R. 284):

Payment of Federal and state taxes	$89,464.96
Purchase of Government bonds	281.25
Payment of personal expenses of Eunice Royce	2,200.00
Loans to or for E. Royce	94,100.00
Balance left in account	19,108.73
Total	$205,154.94

During the years involved, Eunice had a personal checking account in The First National Bank, to which E. Royce sometimes deposited small amounts drawn from the trust account for certain personal expenses of Eunice while she attended college. Such deposits totaled $2,200. (R. 284.)

The sole investment of trust funds in Governmental or other conventional securities amounted to $281.25. This investment consisted of three checks drawn on the trust account in 1944 and 1945, made payable to "Yellow Cab Co." (R. 285.)

The "loans" to E. Royce from the trust account aggregated $94,100 on December 31, 1949. Of this

amount, $7,100 was loaned to Royce, Inc., and the balance of $87,000 to E. Royce, personally. Royce, Inc., owned the Columbia Athletic Club building, and E. Royce was principal stockholder of the corporation. The loans to Royce, Inc., were made in 1948 and 1949, and were repaid in 1950. The loans to E. Royce consisted of three checks drawn on the trust account at the time and in the amounts indicated below (R. 285):

Check No.	Date of Check	Amount
6	Between June 15 and July 10, 1945	$60,000.00
10	December 29, 1945	25,000.00
15	July 10, 1946	2,000.00
	Total	$87,000.00

These loans have not been repaid, and are now evidenced by three renewal notes bearing three per cent interest, the original notes having been canceled. (R. 285.)

These renewal notes are one-year notes made payable to Eunice Mae Royce. The dates of execution, face amounts and other data shown thereon are as follows (R. 486):

Date of Execution	Amount of Note	Repayment—Amount & Date
July 10, 1951	$2,000	$ 200 (6-18-53)
		500 (5- 5-53)
		230 (5- 7-54)
		85 (9-26-53)
July 7, 1952	60,000	3,500 (1-13-54)
		1,000 (2-15-54)
December 26, 1953	25,000	None
	$87,000	$5,515

No interest has been paid and, aside from the above small payments, the loans to E. Royce from the trust account remain unpaid to date. (R. 286.)

The Commissioner determined that Eunice Royce was not a bona fide partner in the partnership and accordingly included in the income of E. Royce the partnership profits in the returns filed in her name. In affirming this determination the Tax Court held that E. Royce and the other parties involved did not in good faith and acting with a business purpose intend to join together with Eunice or with the trust of which she was beneficiary as partners in the conduct of the Seattle partnership. (R. 286.)

SUMMARY OF ARGUMENT

1. Section 115(a) of the Internal Revenue Code of 1939 sets forth the general rule that any distribution by a corporation to its stockholders constitutes a taxable dividend to the extent of its earnings. Section 115(c) provides an exception for distributions made in complete or partial liquidation of a corporation. This exception is then limited by Section 115(g) which provides that redemptions "essentially equivalent to the distribution of a taxable dividend" shall be treated as taxable dividends.

In the case at bar the taxpayers evolved a plan to acquire complete ownership of Oregon Motor Stages, whose stock was worth $750,000, by using $350,000 of Stages' surplus as part payment. This was accomplished by setting up one Bentson as a straw man, an ostensible borrower of $350,000 from ABC and an ostensible stockholder in the corporation. The facts

show, however, and the Tax Court so held, that the loan by ABC to finance part of the purchase price of Stages' stock was in reality made to the taxpayers and not to Bentson. He did not take part in the negotiations leading up to the loan, the parent company of the loan company did not think it was lending the money to him, he did not have a net worth ample enough to undertake such a loan, and E. Royce signed the note with him as co-maker. When this situation is viewed in the light of the various criteria set forth by the courts to determine whether any given distribution is essentialy equivalent to a dividend, it becomes apparent that the Tax Court correctly decided the case. There was no contraction of corporate business, and in fact a retention of earnings was required for the purchase of additional equipment after the war. The reason behind the corporate redemption was not a business consideration but rather was the personal desire of the stockholders from whom sprang the initiative for the distribution. Since the 350 shares ostensibly held by Bentson were actually held for the benefit of all the stockholders, the distribution did not serve to change the proportionate ownership of the stock. Also noteworthy is the fact that prior to 1945 substantial dividends were paid, and in contrast no formal dividends were declared once the corporation was under the control of the taxpayers. The most important criteria, the net effect of the action, shows that precisely the same result was accomplished by the distribution as it took place as would have been accomplished had a formal dividend been declared. The taxpayers were enabled to purchase one hundred

per cent control of a corporation which had a stock value of $750,000 by the expenditure of $400,000 of their own funds and the use of $350,000 of the corporate earned surplus. Various incidental expenses incurred in connection with the loan which were paid by Stages were also dividends to taxpayers.

The Tax Court did not err in admitting the relevant minutes of ABC-Delaware (the loan company's parent) in connection with the loan application. This exhibit is admissible as a business entry. The taxpayers admitted its authenticity and identity. Taxpayers' main complaint appears to be that the Commissioner failed to lay a proper foundation for its reception. However, no contention whatsoever was made at the trial that the exhibit did not represent minutes made "in the regular course" of ABC-Delaware's business, and their trustworthiness is pointed up by the fact that they are routine business entries of a corporation in no way connected with the present litigation. In any event, assuming arguendo the correctness of taxpayers' contentions, the admission of the exhibit was not prejudicial. The Tax Court's decision rested upon much more than the exhibit.

2. A withdrawal of $20,000 in 1945 by E. Royce from Hippodrome, a corporation of which he was the principal stockholder, was a dividend and not a loan. E. Royce executed no note, paid no interest, and the "loan" remains unpaid to date. The taxpayer in his petition to the Tax Court alleged that the funds had been accumulated by Hippodrome for the construction of a building for which there were plans in 1945, and that in anticipation of improved building conditions

the plans were held in abeyance and the corporation made the "temporary loan" until the funds were required. His proof, however, completely failed to support the allegations of the petition and it is apparent that at the time of the so-called loans the corporation had no such reason for accumulating the funds. The Tax Court was correct in subjecting this transaction between a corporation and its controlling stockholder to close scrutiny and properly found that the distribution was a dividend.

3. There are three family partnerships at controversy: The purported interest of Dora Royce in the Yellow Cab companies of Portland and Seattle, and that of Eunice Royce, minor daughter of E. Royce, in the Seattle company. The controlling consideration, as enunciated by the Supreme Court in the *Culbertson* case (p. 742) is—

> whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."

In each of these three instances the purported capital contribution did not originate with the wife and daughter, but rather was a gift from E. Royce. A lack of original capital does not militate against the validity of a family partnership for tax purposes;

however, it is one of the circumstances to be considered in determining whether a bona fide partnership has been established. Where a purported partner has not contributed vital services, has not participated in the management and control of the business, and has not contributed "original capital," under the *Culbertson* case a heavy burden is placed on the taxpayer to show the bona fide intent of the parties to join as partners.

The Tax Court, in reaching its decisions favorable to the Commissioner, duly considered the legal principles set forth by *Culbertson*. As to Dora's purported interests, it is clear that her capital was in the form of a gift made to her contingently upon her joining the partnerships. There were no business reasons for taking her into the partnerships, and it is clear that keeping down family taxes is not of itself "business." Likewise, a so-called moral obligation to ~~gift~~ give a wife because she had been of help to the husband does not constitute a business purpose for her entry into the partnership. As to Dora's services and management control, the Tax Court found that she only "performed certain relatively inconsequential services for the Portland firm," and it is clear that she did not exercise any real dominion or control over her "investments." Even more telling against the taxpayers' contentions is the fact that in reality it was E. Royce and not Dora who enjoyed the income distributed to Dora.

The trust for Eunice, minor daughter of E. Royce, is likewise not a bona fide member of the Seattle partnership. This purported interest, like those of the

wife, was set up with gift capital. There has not even been any attempt to ascribe a business reason for the trust joining the partnership. And the evidence makes it very clear that E. Royce did, in fact, treat the trust's so-called share of partnership income as if it were in reality his own. None of these partnerships are valid for tax purposes.

The decisions of the Tax Court are correct and should be affirmed.

ARGUMENT

I

The Disbursement Of Earnings By Oregon Motor Stages In Payment Of The ABC Note And The Simultaneous Redemption Of The 350 Shares Of Stock Purchased With The Proceeds Of Such Note, Together With The Disbursements For Incidental Expenses Charged By ABC For Making The Loan, Constituted Distributions Essentially Equivalent To Dividends

A. *The statutory scheme*

The general rule as set forth in Section 115(a) of the Internal Revenue Code of 1939 (Appendix, *infra*) is that any distribution either of money or property by a corporation to its stockholders constitutes a taxable dividend to the extent that the corporation has earnings. Out of this general rule an exception is carved by Section 115(c) (Appendix, *infra*) which provides that distributions made in complete or partial liquidation of a corporation will be treated as payments in exchange for the corporate stock even though the distribution may include earnings. The scope of the exception contained in Section 115(c) is,

however, definitely limited by Section 115(g) of the Code (Appendix, *infra*). That section provides that—

> If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

Thus, the general rule as to corporate distributions is set forth in Section 115(a), an exception to this general rule in certain instances is set forth in Section 115(c), and this exception is then limited by Section 115(g).[3]

The purpose behind the enactment of Section 115(g) was to thwart various attempts to disguise ordinary dividends as liquidating distributions. This Court, in *Earle* v. *Woodlaw*, 245 F. 2d 119, 129, certiorari denied, 354 U.S. 942, quoted with approval the statement of the legislative history of the section as set down in *Hyman* v. *Helvering*, 71 F. 2d 342 (C.A. D.C.), certiorari denied, 293 U.S. 570:

> This case describes the legislative history behind Sec. 115(g), 71 F.2d at page 344:

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[3] A reading of the Code provisions relative to corporate distributions, starting with Section 115(a), makes it clear that the taxpayers are in error when they state that the "general rule" is that the proceeds of a stock redemption are to be treated as the proceeds of a sale. (Br. 29.)

> "Suppose * * * the case of two men holding practically the entire stock of a corporation for which each paid $50,000. The corporation, having accumulated a surplus of $50,000 above its cash capital, buys from the stockholders for cash one-half of the stock held by them and cancels it, and the payment is nontaxable because it is a partial redemption of stock. To change this result and make it taxable (g) was written and incorporated into the law."
>
> House, Senate and Conference Reports. H. Rep. No. 1, 69th Congress, first Session, p. 5; S. Rep. No. 52, 69th Congress, First Session, p. 15; H. Conf. Rep. No. 356, 69th Congress, First Session, p. 30.

It is with this legislative purpose in mind, then, that the distributions involved in the case at bar must be scrutinized.

B. ***The loan and purchase of 350 shares were for the benefit of taxpayers***

1. The Tax Court's finding in this respect was not "clearly erroneous"

The factual situation which is before the Court presents a clear instance where the stock redemption should be treated as "essentially equivalent to the distribution of a taxable dividend." The apparent plan which the taxpayers evolved to acquire complete ownership of Stages, whose stock was worth $750,000, by using $350,000 of Stage's funds for payment without incurring the normal tax liability for a dividend distribution, is the type of situation where dividend treatment is required by Section 115(g).

The taxpayers would have this Court view the stock redemption in a vacuum, without any consideration whatsoever of the long series of interrelated transactions which led to the so-called purchase by Bentson of 350 shares. The Tax Court, however, refused to adopt the narrow attitude espoused by taxpayers and found it necessary to consider all of the facts involved in the relatively short time period between the negotiations for the loan to purchase the stock and the redemption of the 350 shares. These events are in three general phases, namely, the purchase on July 2, 1945, of the entire capital stock of Stages consisting of 750 shares for $750,000, 400 shares with funds provided by the taxpayers and 350 shares, with funds borrowed from ABC; the simultaneous transfer of the entire capital stock on July 2, 1945, to ABC as security for the note to ABC in the amount of $350,000; and the disbursement of corporate earnings on September 6, 1945, in the amount of $350,000 in payment of the ABC note and the simultaneous redemption of 350 shares of stock. Whether or not this redemption constitutes a dividend depends to a large extent upon the question of whether the indebtedness to ABC was incurred on behalf of the taxpayers. Thus, the bona fides of Bentson's participation in the purchase of the corporation is of primary concern. It is the position of the Commissioner that Bentson was no more than a straw-man on behalf of the taxpayers in the purchase of the 350 shares and that in reality the taxpayers purchased the entire capital stock of Stages with funds which consisted of $400,000 of their own funds and $350,000 borrowed

from ABC; they then repaid the $350,000 with funds obtained from the corporation.

L. R. Bentson, at the time in question, was an elderly man who occasionally left his home in Canada to visit a niece and two nephews in Portland. He was in Portland sometime around the date of the purchase of the stock, and the taxpayers have attempted to show, although only by the testimony of interested witnesses whose credibility obviously did not impress the Tax Court, that Bentson took an active part in the purchase of the stock and the negotiations for the loan from ABC. The evidence, however, is to the contrary and the Tax Court rightly so held. In fact, E. Royce informed the revenue agents that the financial arrangements with respect to the ABC loan were handled by Jacob and McCulloch, the attorneys for the former stockholders.[4] (R. 583.) Jacob, on the other hand, told the agents that his part in the loan negotiations was limited to introducing E. Royce and Bentson to George Davidson, manager of ABC-Portland, and that the loan negotiations were carried on by them, the same story he told at the hearing. (R. 585.) That Mr. Bentson did not participate in the events leading up to the negotiation of the loan is apparent from the statements of the taxpayers to the revenue agents prior to the trial herein, from the records of ABC and from the fact that negotiations for the loan were made prior to the time Bentson even arrived in Portland, thus making it physically impossible for him to have submitted the application

[4] This statement is, of course, in marked variance with the testimony given by E. Royce during the trial herein.

for the loan, and/or to have participated in the negotiations.

The minutes of ABC-Delaware, the parent company of ABC-Portland through which the loan was obtained, read as follows (R. 223-224):

> A group of outstanding individuals in Portland, headed by Messrs. Barney and Roy Royce and Robert Jacob, desire to purchase the entire capital stock of Oregon Motor Stages * * *. The stock is to be acquired for a price of $750,000. The purchasers intend to buy 400 shares for $400,000, with their own funds. They ask that we extend a line of credit for $350,000, the balance of the purchase price of Oregon Motor Stages stock. We are asked to lend Mr. Roy Royce, personally, the sum of $350,000, on his note, to be secured by all of the capital stock of Oregon Motor Stages.

It is noteworthy that Mr. Bentson, who the taxpayers contend to be the real debtor to ABC, is nowhere mentioned in these minutes. Lending credence to the ABC record is the admission of Niederkrome, made during his interview with the revenue agents, that the taxpayers borrowed the $350,000 from ABC. (R. 594-595, 606-607.) As the agent testified during the hearing (R. 594-595):

> He [Niederkrome] said he did not know whether stock was put up as collateral for the loan by American Business Credit Corporation, but he did know that a loan was obtained and he explained the general financing of the transaction. He said that the new group of stockholders put up four hundred thousand dollars,

and they borrowed three hundred fifty thousand dollars.

The Tax Court found that there was no proof that in July, 1945, Bentson had a net worth ample to undertake the purchase of $350,000 worth of stock. (R. 239.) He lived modestly and left a small estate of approximately $34,000 at the time of his death in 1950, which was only five years after the time of his so-called purchase. While his day-books indicated that he was careful to record his small transactions, there were no entries therein pertaining to the purchase and sale of the Stages stock. (R. 222, 231, 240.)

Additionally, the Tax Court found as a matter of fact that Bentson did not become involved in the transaction until after application for the loan was made by Ezra Royce because he did not arrive in Portland until after that time. (R. 241-242.)

Likewise compelling in support of the Tax Court's determination that the loan was obtained by Ezra Royce on behalf of the taxpayers were the facts that Ezra Royce signed the ABC note as co-maker (R. 225-227); that all of the stockholders put up their stock as collateral for the ABC loan (R. 225); that Stages paid the ABC service charge and interest on the loan (R. 227, 231); that the redemption of the stock was for the same price per share at which it was purchased and that the ABC note was immediately paid. (R. 231). The holding by the Tax Court that Bentson was only a straw-man in this transaction is well supported by the evidence.

This is no more than a run-of-the-mill question of

fact and the finding of the Tax Court must be upheld unless it can be said to be clearly erroneous. *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282; *Commissioner* v. *Scottish American Co.*, 323 U.S. 119. While the ultimate question of whether the distribution was essentially equivalent to a dividend has been held by this Court to be a mixed question of law and fact (*Earle* v. *Woodlaw*, *supra*; *Pacific Vegetable Oil Corp.* v. *Commissioner*, 251 F. 2d 682), the determination that the taxpayers herein and not Bentson incurred this indebtedness is a simple question of fact and the record is replete with evidence in support of it. Bentson was merely allowing his name to be used in an attempt to purchase the 350 shares of stock with accumulated earnings of Stages without the tax liability of a dividend distribution. He held the stock in behalf of the other stockholders, the taxpayers herein.

2. The Tax Court did not err in admitting the minutes of ABC-Delaware in connection with the loan application

The taxpayers contend that Exhibit A was improperly admitted. This exhibit consists of a certification by the treasurer and assistant secretary of Crown Finance Company, Inc., a Delaware corporation which was formerly named the American Business Credit Corporation, attaching a copy of the minutes of a meeting of the executive committee of ABC-Delaware held on June 20, 1945. (Br. 5a-11a.)

The parties stipulated that Exhibit A "may be offered in evidence at the trial of the above-entitled cases without further identification or authentica-

tion, subject, however, to any and all other objections as counsel may make thereto at the trial of said cases." (R. 213-214.)

During the course of the trial, taxpayers objected to the exhibit's admission as follows (R. 613-614):

> * * * we strenuously object to its admission in evidence on the ground that it is incompetent, irrelevant, immaterial, and purely hearsay. * * * Here, there is an affidavit by a person who was not an officer of the corporation at the time the affidavit—at the time the transaction took place, he was the Secretary at the time the affidavit was made—he—certifies to that affidavit—through that affidavit that the photostat there is a true copy of minutes of a certain meeting. Those minutes, however, report a report of Mr. Davidson who is dead. There is no showing that Mr. Royce or Mr. Jacob or Mr. Bentson or anybody else was back east. There is no evidence that they were there; that they knew what Mr. Davidson was saying. The affidavit, the report of Mr. Davidson, at that Executive Committee in the east was the purest kind of hearsay. He was the Manager out here trying to get a loan through. And we weren't—no party—no purchaser was there being represented. I want it clearly understood that I have stipulated that I have no objection to the authenticity or to the identity of this thing, but I have strenuous objections on the grounds of materiality and hearsay. * * * And here, it is the purest kind of hearsay, with none of these people there whom he seeks to bind or to charge with whatever is in those minutes. Furthermore, I point out in the affidavit, that in paragraph six of the affidavit,

> the gentleman who made it, attempts to state something about a loan when the affidavit bears the date of 1955, the 21st day of April, about something that happened ten years before, when he wasn't present or knew anything about it. And for that reason, I think it is the purest hearsay. We object to the photostat and to all parts of the affidavit, insofar as they state facts.

This exhibit is admissible as a business entry. As the taxpayers correctly state, 28 U.S.C., Section 1732 (Appendix, *infra*), is applicable to proceedings in the Tax Court. This statute provides:

> § 1732. *Record made in regular course of business; photographic copies.*
>
> (a) In any court of the United States and in any court established by Act of Congress, any writing or record, whether in the form of an entry in a book or otherwise, made as a memorandum or record of any act, transaction, occurrence, or event, shall be admissible as evidence of such act, transaction, occurrence, or event, if made in regular course of any business, and if it was the regular course of such business to make such memorandum or record at the time of such act, transaction, occurrence, or event or within a reasonable time thereafter.
>
> All other circumstances of the making of such writing or record, including lack of personal knowledge by the entrant or maker, may be shown to affect its weight, but such circumstances shall not affect its admissibility.
>
> * * * *

The statute was enacted to do away with the common-law requirement that business records must be

identified by the persons who made them. See, e.g., *Palmer* v. *Hoffman*, 318 U.S. 109. In that case the court stated (p. 115):

> The several hundred years of history behind the Act (Wigmore, *supra*, §§ 1517-1520) indicate the nature of the reforms which it was designed to effect. It should of course be liberally interpreted so as to do away with the anachronistic rules which gave rise to its need and at which it was aimed.

If the exhibit fits within the purview of the Business Records Act, as the Commissioner contends, it is admissible despite the common law rule of hearsay. The main complaint about the exhibit appears to be that the Commissioner failed to lay a proper foundation for its reception. In this respect the above set out objections of taxpayers' counsel during the course of the trial should be noted. No contention whatsoever was made that the exhibit did not represent minutes made "in regular course" of ABC-Delaware's business.[5] There is no question at all that Exhibit A

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[5] Compare *United States* v. *Feinberg*, 140 F. 2d 592 (C.A. 2d), cited by taxpayers, where the specific objection was made that there had been no testimony that certain corporate books (not minutes) had been kept in the regular course of business. Also see *Clainos* v. *United States*, 163 F. 2d 593 (C.A. D.C.), where the court held that a photograph of the accused which had on its back a series of notations as to convictions of various crimes was not admissible over objection; the court held that these were not the type of records encompassed by the business record statute, particularly where Congress specifically provided in the District Code for a different method of proving convictions. Likewise in *Schering Corp.* v. *Marzall*, 101 F. Supp. 571 (D.C. D.C.),

is a correct copy of the minutes of the meeting in question.[6] And the fact that corporations keep minutes would appear to be subject to judicial notice. Indeed, under the laws of Delaware, the state of incorporation of ABC-Delaware, there is a mandatory requirement that such minutes be kept. 8 Delaware Corporation Code, Section 142.

Once again, it must be repeated that taxpayers have admitted the authenticity and identity of this document. (R. 213-214, 613-614.) Thus, the argument devoted to lack of authenticity (Br. 49) is aimed at a point which has been already conceded by taxpayers.

The next point made is that the exhibit is not trustworthy, and that the crux of trustworthiness is that the records are routine or automatic reflections of business transactions. Taxpayers again ignore the point that corporate minutes are entries made in the routine course of business. The trustworthiness of the minutes here under consideration is apparent when the circumstances are examined. They are admittedly a summarized version of the meeting of ABC-Delaware's executive committee. But we do not

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the papers excluded in a patent action were not corporate minutes, but rather were laboratory notebooks which were not identified by the person who made the entries or by any person who saw them contemporaneously with the events they purported to record.

[6] "I want it clearly understood that I have stipulated that I have no objection to the authenticity or to the identity of this thing, but I have strenuous objections on the grounds of materiality and hearsay." (R. 613-614.)

understand that condensation renders such records inadmissible. They are the minutes of a corporation which is in no way connected with the present litigation, which has and had at the time of the meeting "no ax to grind" in relation to these cases. They merely considered whether or not a certain loan should be granted by their subsidiary and made a decision thereon.

As to the contention that Davidson might have been prone to exaggeration in his eagerness to have the loan granted (which is, of course, pure conjecture at the most), we can only refer to the statute which provides that "All other circumstances of the making of such writing or record, including lack of personal knowledge by the entrant or maker, may be shown to affect its weight, but such circumstances shall not affect its admissibility."

In any event, assuming arguendo the correctness of all of the taxpayers' contentions in this respect, the admission of the exhibit was not prejudicial. As noted in point B(1) of this section, the Tax Court rested its decision upon much more than Exhibit A. The vagueness of interested witnesses at the time of the revenue agents' investigation vis-a-vis their specific and detailed tales many years later at the trial, the net worth of Bentson which was insufficient to obtain a loan of such magnitude, the securing of all the capital stock of Stages for the loan, the signing of the note by E. Royce, etc., all went to prove the Commissioner's case. The argument that this whole case rested on Exhibit A is patently untenable.

C. *The distribution of $350,000 was essentially equivalent to a dividend*

The situation, stripped of all the paper machinations that went on, was as follows. The taxpayers purchased Stages for $750,000. They put up $400,000 of their own funds and borrowed the remaining $350,000 from ABC, putting up all of the capital stock as collateral. Then, in order to pay off the note, they had Stages redeem 350 shares of stock, financing the purchase from accumulated earnings, and using the money so obtained, paid the ABC note. Viewed thusly, there is no question that the redemption was essentially equivalent to a dividend. The various criteria used to determine whether or not a distribution is to be treated as a dividend were set forth and discussed by this Court in its recent decision of *Earle* v. *Woodlaw*, *supra*. See also *Pacific Vegetable Oil Corp.* v. *Commissioner*, *supra*; *Phelps* v. *Commissioner*, 247 F. 2d 156 (C.A. 9th); *Flanagan* v. *Helvering*, 116 F. 2d 937 (C.A. D.C.). Those criteria, as applied to this case, are discussed below.

First, however, an aspect not present in *Earle* v. *Woodlaw*, *supra*, should be noted. Here the stockholders had not paid for the redeemed 350 shares of stock with their own funds and accordingly they did not receive cash in hand on the redemption of the stock. This is a case where the redemption of stock was accompanied by use of corporate earnings for payment of the purchase price of the redeemed stock for the benefit of the stockholders. But it is well settled that the use of corporate earnings for the purchase and redemption of stock for the benefit of

the stockholders, as distinguished from benefit to the corporate enterprise, constitutes a taxable dividend to the stockholders so benefitted. See *Wall* v. *United States*, 164 F. 2d 462 (C.A. 4th); *Holloway* v. *Commissioner*, decided December 12, 1951 (1951 P-H T.C. Memorandum Decisions, par. 51,359), affirmed *per curiam*, 203 F. 2d 566 (C.A. 6th); *Woodworth* v. *Commissioner*, 218 F. 2d 719 (C.A. 6th).

I and II. *Did the corporation adopt any plan or policy of contraction of its business activities? Did it follow an orderly procedure looking toward its ultimate dissolution, or its ultimate contracted operations?*

There is no evidence at all that Stages had a plan or policy of contraction of its corporate business. The record shows, in fact, that just the opposite was the case. A large surplus had been built up as a reserve for the purchase of additional equipment, and in the tax return of Stages for 1946 a statement appears that retention of earnings was required for replacement of worn equipment and further expansion. Long-term obligations were incurred in 1945, 1946 and 1947 to provide funds for new equipment. The need for money for this purpose was known when the stock was redeemed, and without the redemption these purchases could have been made out of Stages' reserve.[7] (R. 234-235, 243.) There was no intent to contract corporate activities, and in fact the corporation continued to operate, and at a profit. (R. 235.)

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[7] At the end of 1944 Stages had among its assets governmental securities aggregating $546,172.58. At the end of 1945, after the redemption it retained only $755.61 of such securities. (Balance Sheet Schedule attached to Exhibit 4; R. 233.)

III. *Did the initiative for the corporate distribution come from the corporation, based on usual business considerations, or did it come from the stockholders for their own purpose?*

As discussed above, it is clear that there was no plan of contraction of corporate activity whatsoever. Likewise there was no indication of overcapitalization of Stages. The reason behind the corporate redemption was not a business consideration of the corporation but rather was the personal desire of the stockholders. The corporate activities of Stages were hampered by the redemption, rather than enhanced. All of the initiative for the distribution sprang from the personal considerations of the stockholders.

IV. *Is proportionate ownership of stock changed?*

The 350 shares ostensibly held by Bentson were actually held for the benefit of all the stockholders. Their stock secured the loan from ABC which enabled the purchase of the 350 shares and the indebtedness was incurred in their behalf. Thus, after the redemption each of the taxpayers herein held precisely the same proportional interest in the corporation which they had held prior to the redemption. The argument that Treasury Regulations 111, Section 29.115-9, Appendix, *infra*, which provides that the redemption of all of the stock of one stockholder will not be treated as a dividend is applicable in this case and is being ignored by the Commissioner is not correct. The regulation is intended to cover only those situations involving bona fide stockholders and it is patently not applicable to persons holding stock in

form only. Here the redemption in substance was pro rata.

V. *What were the amounts, the frequency, and the significance of dividends paid in the past?*

Stages had paid substantial dividends in the years prior to taxpayers' acquisition of the stock. (R. 233.) The amount of these dividends are not of record. In contrast, no formal dividends were declared in 1945 and 1946, nor in any other year under the operation of the taxpayers. (R. 235.)

VI, VII and VIII. *Does the capitalization, at the time of cancellation of the stock, represent capital paid in, or earnings from the business? Was there a sufficient accumulation of earned surplus to cover the distribution, or was it partly from capital? Was there a maintenance of a relatively similar amount of capital liability, or did that figure decrease to a degree somewhat comparable to the purported distribution of capital?*

There is nothing of record to indicate the original source of the capital. There can be no dispute, however, of the fact that at the time of the distributions Stages had undivided profits in the amount of $446,552.78 (R. 233-234), an amount well in excess of the distributions of $350,000, $4,315.07, and $3,739.73. (R. 227, 231.) The amounts distributed would clearly have been available for purposes of the declaration of a formal dividend. See *Goldstein* v. *Commissioner*, 113 F. 2d 363 (C.A. 7th). The capital stock shown on the books of Stages decreased from $100,000 to $40,000. (R. 233-234.) This, however, does not tend to show any contraction in the activity of Stages.

IX. *Was there good faith, or bad, in the action of the Board of Directors?*

This element has been held to be of no real importance. *Hirsch* v. *Commissioner*, 124 F. 2d 24 (C.A. 9th); *Earle* v. *Woodlaw*, *supra*; *Pacific Vegetable Oil Corp.* v. *Commissioner*, *supra*; *Patty* v. *Helvering*, 98 F. 2d 717; *Commissioner* v. *Quackenbos*, 78 F. 2d 156 (C.A. 2d); *Flanagan* v. *Helvering*, *supra*.

X. *What was the net effect of the actions taken?*

This is the most important of the many criteria considered in such cases. *Earle* v. *Woodlaw*, *supra*; *Pacific Vegetable Oil Corp.* v. *Commissioner*, *supra*; *Hirsch* v. *Commissioner*, *supra*; *Flanagan* v. *Helvering*, *supra*; *Hyman* v. *Helvering*, *supra*; *Kirschenbaum* v. *Commissioner*, 155 F. 2d 23 (C.A. 2d), certiorari denied, 329 U.S. 726; *Boyle* v. *Commissioner*, 187 F. 2d 557 (C.A. 3d), certiorari denied, 342 U.S. 817; *Commissioner* v. *Roberts*, 203 F. 2d 304 (C.A. 4th); *McGuire* v. *Commissioner*, 84 F. 2d 431 (C.A. 7th), certiorari denied, 299 U.S. 591; *Commissioner* v. *Snite*, 177 F. 2d 819 (C.A. 7th); *Vesper Co.* v. *Commissioner*, 131 F. 2d 200 (C.A. 8th). In this case, as in *Pacific Vegetables Oil Corp.*, *supra*, the corporation was in substantially the same position before the redemption as after it. Business was carried on in the same manner. Stages continued to operate under its permanent franchise with the Interstate Commerce Commission, and it continued to serve the people who desired to use its facilities. (R. 234.) Precisely the same result was accomplished by the actions taken as would have been accomplished

by the distribution of a dividend. Both the earned surplus and Government bonds were reduced in the same manner as probably would have occurred had a formal dividend been declared. The taxpayers were enabled to purchase one hundred per cent control of a corporation which had stock of a value of $750,000 outstanding by the expenditure of $400,000 of their own funds and the use of the corporate earned surplus of $350,000. There is no difference at all in the net effect of the actions taken in this case and those that would have occurred had a dividend been declared.

D. *The incidental expenses paid by Stages were dividends to the taxpayers*

The small point remaining concerns the incidental expenses paid by Stages to ABC in connection with the loan. From the facts and arguments set forth above, it is apparent that Stages was paying obligations of the taxpayers. These obligations covered not only the $350,000 purchase price of the redeemed stock but also $4,315.07 for servicing fees and $3,739.73 for interest. Section 115(a) of the Code, *supra*, defines "dividend" as "any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913." Thus, just as the purchase price of the stock is a dividend as having been paid for the benefit of the stockholders, a payment by the corporation of personal obligations of its stockholders falls within the Section 115(a) definition of a dividend. See *Ferro* v. *Commissioner*, 242 F. 2d 838 (C.A. 3d); *Wall* v. *United States*, *supra*; *Greens-*

pon v. *Commissioner*, 229 F. 2d 947 (C.A. 8th). As the Fourth Circuit stated in *Wall* v. *United States*, *supra*, p. 464:

> It cannot be questioned that the payment of a taxpayer's indebtedness by a third party pursuant to an agreement between them is income to the taxpayer. *Douglas* v. *Willcuts*, 296 U.S. 1, 9, 56 S. Ct. 59, 80 L. Ed. 3, 101 A.L.R. 391; *United States* v. *Boston & Maine R. Co.*, 279 U.S. 732, 49 S.Ct. 505, 73 L. Ed. 929; *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 49 S. Ct. 499, 73 L. Ed. 918. The transaction is regarded as the same as if the money had been paid to the taxpayer and transmitted by him to the creditor; and so if a corporation, instead of paying a dividend to a stockholder, pays a debt for him out of its surplus, it is the same for tax purposes as if the corporation pays a dividend to a stockholder, and the stockholder then utilizes it to pay his debt.

E. *The Tax Court's decision was correct*

The Tax Court was clearly correct in terming all of the distributions in question to be essentially equivalent to dividends.

The argument that the Tax Court in making this decision regarded the Commissioner's deficiency determination as affirmative evidence (Br. 56-64) is clutching at straws. To attempt to argue that the Tax Court did not consider the Commissioner's evidence but rather relied upon the presumption is to ignore the extensive findings of fact made by the Tax Court, in great part from the positive evidence introduced during the course of the trial by the Commis-

sioner. The Tax Court was saying that the evidence preponderated in favor of the deficiency as determined by the Commissioner and it was clearly correct in so holding.

II

The $20,000 Disbursement By Hippodrome To E. Royce Was Not A Loan And Was Taxable To Him As A Dividend

It is the position of the Commissioner that a withdrawal of $20,000 by the taxpayer E. Royce in 1945 from Hippodrome Amusement Company was a dividend and is taxable as such. E. Royce, on the other hand, contends that this withdrawal constitutes no more than a loan to him from the corporation.

The facts are simple. E. Royce was the principal stockholder, officer and director of the corporation. The other stockholders were his brother, B. Royce, who was inactive and away most of the time; Niederkrome, his brother-in-law, who worked under E. Royce and followed his instructions and orders; and one Bartle, concerning whom there is no evidence. (R. 258, 518-519). The amount of $20,000 was withdrawn in 1945 by E. Royce with the consent and agreement of his brother and brother-in-law. He simply requested the money and it was given to him, admittedly a normal procedure in the conduct of the affairs of the corporation. There were no corporate minutes authorizing the payment, and the amount was recorded on the books as an account receivable. E. Royce executed no note or other evidence of indebtedness, he paid no interest at any time, and the alleged loan remains upaid although he was at all times

financially able to repay the amount withdrawn. (R. 258-259, 521.) As far as appears from the record, no dividends were ever formally declared or paid by Hippodrome in the years before or after 1945, although its financial and operating condition would have warranted the distribution of dividends. (R. 260.) E. Royce testified that this distribution was a corporate loan to him (R. 412, 419), that the funds had been accumulated by Hippodrome for the purpose of constructing a building on its unimproved property in Seaside, and that it was his intention to repay the amount as soon as the funds were required for construction (R. 413-414, 419).

The Tax Court petition filed on behalf of E. Royce alleged *inter alia* that Hippodrome had a plan certain in 1945 to build a downtown ticket office and terminal building for Oregon Motor Stages; that it had "been accumulating its funds for that purpose, but the construction of a building in accordance with the plan of the company was being held in abeyance" in anticipation of improved building conditions; and that the company therefore advanced "$20,000.00 from its said building funds as a temporary loan and/or until such time as the said company's building program could be put into effect." (R. 59, 70-71, par. V(t) and (u).)

The Tax Court held that the distribution was a dividend within the meaning of Section 115(a) of the Code.[8] (R. 262.) The various principles of law

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[8] Section 115(a) defines "dividend" thusly:

> The term "dividend" when used in this chapter (except in section 201(c)(5), section 204(c)(11) and sec-

involved herein are well-settled. As the Court of Appeals for the Eighth Circuit stated in *Wiese* v. *Commissioner*, 93 F. 2d 921, 922, certiorari denied, 304 U.S. 562:

> The principles of law invoked by each party are relatively simple. When the principal shareholder of a corporation makes a permanent withdrawal of funds from the company, he is deemed to have received income at the time of withdrawal, although the formalities of a dividend distribution have not been observed and the payment is recorded on the books of the company as a loan. *Chattanooga Savings Bank* v. *Brewer*, 6 Cir., 17 F. 2d 79; cf. *Christopher* v. *Burnet*, 60 App. D.C. 365, 55 F. 2d 527; *Anketell Lumber & Coal Co.* v. *United States*, 1 F. Supp. 724, Ct. Cl.
>
> But if the stockholder borrows money from the company, and subsequently the company cancels the debt, income accrues to the stockholder at the time when the character of the withdrawal changes from a loan to a distribution of profits. *Cohen* v. *Commissioner*, 6 Cir., 77 F. 2d 184; cf. *Fitch* v. *Helvering*, 8 Cir., 70 F. 2d 583.

The Court in *Wiese* makes it clear that such a determination is a question of fact, and upon review ~~said~~ (p. 923)—

"Such a determination of fact is not to be set

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tion 207(a)(2) and (b)(3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits umulated after February 28, 1913 * * *

> aside by a court even if upon examination of the evidence it might draw a different inference." *Palmer* v. *Helvering, Commissioner*, 58 S. Ct. 67, 70, 82 L. Ed. ——, decided November 8, 1937; *Elmhurst Cemetery Company* v. *Commissioner*, 300 U.S. 37, 40, 57 S. Ct. 324, 325, 81 L. Ed. 491; *Helvering* v. *Rankin*, 295 U.S. 123, 131, 132, 55 S. Ct. 732, 736, 79 L.Ed. 1343.

See also *Allen* v. *Commisioner*, 117 F. 2d 364 (C.A. 1st); *Regensburg* v. *Commissioner*, 144 F. 2d 41 (C.A. 2d), certiorari denied, 323 U.S. 783; *Lengsfield* v. *Commissioner*, 241 F. 2d 508 (C.A. 5th).

The facts that the withdrawal was recorded on the corporate books as a debt against E. Royce, that it was not proportionate to holdings of stock nor participated in by all the shareholders and that the formalities of a dividend declaration were lacking are not conclusive against a finding that the withdrawal was a dividend. Such was the precise holding of the Second Circuit in *Regensburg* v. *Commissioner*, *supra*, where the court also cited for this well-settled point (p. 44) the following cases: *Chattanooga Sav. Bank* v. *Brewer*, 17 F. 2d 79 (C.A. 6th), certiorari denied, 274 U.S. 751; *Hadley* v. *Commissioner*, 36 F. 2d 543 (C.A. D.C.); *Christopher* v. *Burnet*, 55 F. 2d 527 (C.A. D.C.); *Anketell Lumber & Coal Co.* v. *United States*, 1 F. Supp. 724 (C. Cls.). See also *Paramount Richards Th.* v. *Commissioner*, 153 F. 2d 602 (C.A. 5th); *58th St. Plaza Theatre* v. *Commissioner*, 195 F. 2d 724 (C.A. 2d); *Cleveland Shopping News Co.* v. *Routzahn*, 89 F. 2d 902 (C.A. 6th).

The taxpayer, in his petition to the Tax Court,

stated that the funds had been accumulated for the construction of a building for which there were plans in 1945, and that in anticipation of improved building conditions the plans were held in abeyance and the corporation therefore made the "temporary loan." His proof, however, did not support the allegations of the petition. It was testified by both E. Royce and Niederkrome that there were no such plans for building in 1945. (R. 420-421, 519-520.) Thus such a factor was of no relevance whatsoever in determining whether or not a loan was made in 1945. Had the evidence supported the petition the Tax Court might possibly have inferred that there was present an intent to repay the corporation as soon as building started. However, from the evidence put forward by taxpayer, there is no indication at all that Hippodrome, at the time of the distribution, had any plans for construction which would tend to prove that the $20,000 was to be returned to it. The evidence of taxpayer as to *subsequent* building plans is of course of absolutely no relevance as to the 1945 transaction.

It has frequently been held that transactions between a corporation and its controlling stockholders are subject to special scrutiny. See, e.g., *Higgins* v. *Smith*, 308 U.S. 473; *Ingle Coal Corp.* v. *Commissioner*, 174 F. 2d 569 (C.A. 7th). And the Tax Court here was well-warranted in applying such special scrutiny to a situation where a so-called loan has been outstanding since 1945 to a controlling stockholder, where there is only the testimony of interested witnesses that the distribution was a loan and not

a dividend, where the corporation paid no other dividends, and where the stockholder who received the "loan" had a large net worth at the time of the distribution. The Tax Court, which had an opportunity to observe the witnesses, inferred from all these facts that the distribution was a dividend. This holding is patently not erroneous and should be affirmed.

III

The Tax Court Did Not Err In Finding, Upon The Record As A Whole, That The Parties Did Not Intend Dora To Be A Bona Fide Partner In Either The Portland Or Seattle Partnerships Or Eunice (Or The So-Called "Trust") To Be A Bona Fide Partner In The Seattle Partnership

A. *Introduction*

There are three family partnerships at controversy in this case. The first involves the validity of a so-called partnership between E. Royce and Dora Royce, husband and wife, in the Yelow Cab Company of Portland, the second involves the same parties in the Yellow Cab Company of Seattle, and the third involves E. Royce and the Eunice Royce Trust in the Yellow Cab Company of Seattle. Eunice Royce is the daughter of Dora and E. Royce. In each instance the Commissioner determined that all of such income was taxable to the husband and father, E. Royce. After trial, the Tax Court, upon the record as a whole, affirmed such determinations. Since the same general legal principles control the disposition of each of these three issues, we will first discuss the applicable case law and then refer specifically to each of the purported partnerships.

B. *General principles*

The rules of taxation involved in family partnership cases are well known to this Court. See, e.g., *Parker* v. *Westover*, 186 F. 2d 49, 221 F. 2d 603, 248 F. 2d 490; *Smith* v. *Westover*, 237 F. 2d 201; *Pike* v. *United States*, 231 F. 2d 688; *Sellers* v. *Commissioner*, 218 F. 2d 380; *Snyder* v. *Westover*, 217 F. 2d 928; *Toor* v. *Westover*, 200 F. 2d 713.

The controlling principles were enunciated in *Commissioner* v. *Tower*, 327 U.S. 280, and *Lusthaus* v. *Commissioner*, 327 U.S. 293, and were reaffirmed and clarified in *Commissioner* v. *Culbertson*, 337 U.S. 733. "The issue is who earned the money and that issue depends on whether this husband and wife really intended to carry on business as a partnership." *Commissioner* v. *Tower*, *supra*, p. 289. As reiterated in the *Culbertson* case, *supra*, p. 742, the test is—

> whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.

Thus, while the ultimate question of fact is whether the parties intended in good faith to join in partnership, their understanding of what a partnership is must conform to the legal standards of what consti-

tutes a partnership for tax purposes. The Supreme Court has defined a partnership for tax purposes as "an organization for the production of income to which each partner contributes one or both of the ingredients of income—capital or services." *Commissioner* v. *Culbertson*, *supra*, p. 740. That each partner must contribute either capital or services was repeatedly emphasized in the *Culbertson* case. For example (pp. 744-745)—

> If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient.

And the capital contributed must be capital of which the partner was the true owner. In remanding the *Culbertson* case to the Tax Court for the purpose of ascertaining which if any of the taxpayer's sons were partners with him, the Court said (p. 748):

> As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital *of which they were the true owners*, * * * [Italics supplied.]

There is no dispute that in each of these three issues the purported capital contribution did not originate with the wife and daughter. Thus, as part and parcel of the planned formation of the partnerships,

E. Royce gave to his wife and the trust set up for his daughter shares of stock in the predecessor corporations. The capital so obtained must be classified as gift capital. *Smith* v. *Henslee*, 173 F. 2d 284 (C.A. 6th).

We wish to make it clear at the outset, however, that the Commissioner has not based his case in these three situations solely on the fact that the wife and daughter did not contribute original capital. The *Culbertson* case does not allow for such a position as a matter of law. See *Culbertson*, *supra*, pp. 745-747. As this Court stated in *Sellers* v. *Commissioner*, 218 F. 2d 380, 383:

> While the absence of a contribution of original capital is not conclusive, it is a circumstance to be considered when determining whether a bona fide partnership has been established. *Commissioner of Internal Revenue* v. *Culbertson*, *supra*; *Harkness* v. *Commissioner of Internal Revenue*, 9 Cir., 193 F. 2d 655.

On the other hand, a situation where a purported partner has not contributed vital services, has not participated in the management and control of the business, and has not contributed "original capital," while not conclusive as a matter of law, "has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners." *Commissioner* v. *Culbertson*, *supra*, p. 744; *Wisdom* v. *United States*, 205 F. 2d 30 (C.A. 9th); *Feldman* v. *Commissioner*, 186 F. 2d 87, 90-91 (C.A. 4th).

In this as in many other fields of taxation it is

the substance of the matter which is controlling.[9] The fact that the form of each of these transactions indicates that the wife and Eunice's trust owned the applicable interests in the profits is not the end of the inquiry, for it must be determined whether they were, in substance, the "true" owners of the capital. *Commissioner* v. *Culbertson, supra*, p. 748. This in turn depends in part upon whether the purported partner exercised an owner's right of control over the interest. The answer to this question in the case at bar is resolved by inspecting the dominion retained by E. Royce over the partnership interests and the proceeds therefrom. The Court in *Culbertson* (p. 747) indicated that where the alleged partnership rests upon a contribution of gift capital and no services are thereafter performed, a valid partnership for tax purposes exists only if the donee "exercises dominion and control over that property—and through that control influences the conduct of the partnership and the disposition of its income * * *." See also *Helvering* v. *Clifford*, 309 U.S. 331; *Helvering* v. *Horst*, 311 U.S. 112; *Commissioner* v. *Sunnen*, 333 U.S. 591; *Corliss* v. *Bowers*, 381 U.S. 376. The quantum of enjoyment by Dora and Eunice (through

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[9] It is fundamental that, inasmuch as taxation is concerned with economic realities rather than legal technicalities, the substance rather than the form of a transaction governs its federal income tax effect, and literal compliance with the words of a section of the Code does not suffice *per se* to bring the transaction within it. *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Higgins* v. *Smith*, 308 U.S. 473; *Burnet* v. *Wells*, 289 U.S. 670; *Gregory* v. *Helvering*, 293 U.S. 465; *Commissioner* v. *Culbertson, supra.*

the trust) of the fruits of the partnership is therefore a major factor. *Commissioner* v. *Culbertson*, p. 747.

The purpose of the formation of the partnership is also important. The *Culbertson* test specifically requires that the parties act with a "business purpose" (p. 742) and this Court has considered that factor in determining the effect of family partnerships for tax purposes (*Parker* v. *Westover*, 248 F. 2d 490; *Pike* v. *United States*, *supra*).

The Tax Court, quoting the guideposts which *Culbertson* set forth as indicative of the intent of the parties to join together in the conduct of an enterprise in good faith and acting with a business purpose, concluded (R. 278) "that the parties involved at no time really and truly intended Dora to be a bona fide partner in carrying on the business of the Portland and Seattle partnerships" and that E. Royce (R. 287) "did not in good faith and acting with a business purpose intend to join together with Eunice or the trust of which she was beneficiary as partners in the present conduct of the Seattle partnership."

The determination of this matter of intent is, of course, a question of fact. *Culbertson*, pp. 742-743. As such, the decision of the Tax Court must be affirmed if it cannot be shown to be "clearly erroneous." *Toor* v. *Westover*, 200 F. 2d 713 (C.A. 9th); *Wisdom* v. *United States*, 205 F. 2d 30 (C.A. 9th); *Harkness v. Commissioner*, 193 F. 2d 655 (C.A. 9th); *Smith* v. *Westover*, 237 F. 2d 201 (C.A. 9th). To reverse, the court must, as stated in *Toor* v. *Westover*, *supra*, p. 717, be—

> left with a "definite and firm conviction that a mistake has been committed." *United States* v. *United States Gypsum*, 1948, 333 U.S. 364, 395, 68 S. Ct. 525, 542, 92 L. Ed. 746; see *Grace Bros., Inc.* v. *Commissioner*, 9 Cir., 1949 173 F. 2d 170, 173-174.

The facts concerning the Yellow Cab partnerships of Portland and Seattle provide ample evidence that the Tax Court did not make any such mistake in the instant cases.

C. *The wife Dora's purported partnership interests*

The Tax Court, as stated above, in arriving at its findings, duly examined the factors which the Supreme Court in *Culbertson* suggested throw light on the true intent of the parties. These factors can be discussed under three headings: First, the circumstances incident to Dora's supposed entry into the partnership; second, the extent of services performed and of management and control which she exercised over her purported interest; and third, the extent to which she had the use and enjoyment of distributions of the partnership.

1. Circumstances incident to entry

For a long time prior to the formation of both partnerships, the taxpayer E. Royce and his associates were stockholders of the corporations which ran the Yellow Cab business in Portland and Seattle. The partnerships were formed under the same style and name on August 1, 1942, and May 1, 1944, respectively, to operate the businesses conducted by the corporations. The corporations were dissolved

and the assets transferred forthwith to the partnerships; the conduct of businesses remained unchanged and the same persons continued to operate and control the businesses as they had done before the formation of the partnerships. The only change was the addition of Dora Royce and Isabelle Royce,[10] now deceased, the wife of B. Royce, as purported members of the Portland partnership and the addition of Dora and E. Royce as trustee for Eunice as purported members of the Seattle partnership.

Dora's capital contribution came from her husband in the form of donated stock of the corporations intended for dissolution. It is quite clear that her husband made the gifts of stock pursuant to and in anticipation of the plan to dissolve the corporations and transfer the assets to the partnerships. Even more significant, however, is the fact that the stock transfers were made contingent upon her joining the partnerships and for the sole purpose of qualifying her for admission thereto.[11] (R. 277.) It is clear

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[10] The Commissioner made no determination in regard to Isabelle's partnership interest since Isabelle and B. Royce lived in Washington, a community property state, during the taxable years, and the income received by them constituted community income equally divisible between them.

[11] On direct examination E. Royce testified as follows concerning the Portland gift (R. 428-429):

> Q. * * * Now, when you gave—when you gave the stock certificate to Mrs. Royce, what was your intention with respect to the gift?
>
> A. I intended that she become a partner in the company.
>
> Q. Well, was the gift—was the gift—have any con-

that it was not Dora's decision to become a partner, but that of her husband. There is no evidence that she played any part whatsoever in formulating the terms of either of the partnership agreements.

In addition, all indications are that there were no business purposes for taking Dora into the partnerships. The Supreme Court has said that to be a valid

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ditions to it, of any kind?

A. None whatever.

Q. Was it—was she obligated to become a partner in the company, when you gave it to her?

A. Yes.

Then on cross-examination he testified (R. 450):

Q. Now, you—all right—you testified on direct examination, that when you turned over the stock to your wife, Dora Royce, you intended her to become a partner in the company?

A. That's right.

Q. And you stated that she was morally obligated to become a partner? A. Yes.

Q. You wouldn't have given her the stock, if she hadn't felt that way about it—if she hadn't felt that she was obligated to become a partner?

A. Well, she—she was—being as she was of so much help to me, and so on, that I felt morally obligated to do it.

Q. That was the purpose of giving—making the gift of stock? A. To make her a partner.

Q. That's right. A. That's right.

Subsequently, after the noon recess E. Royce sought to retract the above testimony in answering questions relating to the Seattle partnership. (R. 464.) On the next day, when he was recalled to the witness stand by his attorneys, he repudiated his former testimony, saying that the gift of stock in each instance was made (R. 569) "without any condition whatever. It was an outright gift. I was in hopes that she would become a partner, but she was under no obligation to do so."

partnership for tax purposes the parties must intend to join together in good faith "and acting with a business purpose." *Commissioner* v. *Culbertson, supra,* p. 742. While it is perfectly permissible to conduct business in such a way as to minimize taxes, the adoption of a family partnership for the sole purpose of splitting income is not acting with a business purpose, for "keeping down taxes is not of itself 'business'." *Slifka v. Commissioner,* 182 F. 2d 345, 346 (C.A. 2d): Accord: *Smith* v. *Westover,* 237 F. 2d 201 (C.A. 9th); *Parker* v. *Westover,* 248 F. 2d 490 (C.A. 9th). The fact that E. Royce felt "morally obligated" to give his wife stock because she had been of so much help to him (R. 450) does not, of course, constitute a business purpose for her entry into the partnerships. See *Parker* v. *Westover,* 248 F. 2d 490 (C.A. 9th); *Smith* v. *Westover, supra;* compare *Pike* v. *United States,* 231 F. 2d 688 (C.A. 9th); *Brodhead* v. *Commissioner,* 18 T.C. 726, affirmed *per curiam,* 210 F. 2d 652 (C.A. 9th); *Forman* v. *Commissioner,* 199 F. 2d 881 (C.A. 9th).

2. Services performed, management and control

Dora did not contribute any services or substance or participate in the actual management and control of either partnership. The Tax Court found that she "performed certain relatively inconsequential services for the Portland firm, similar services for the Seattle partnership being performed by an employee." (R. 277.) These services comprised checking cabs and drivers, and were of such a nature that

they could be performed while shopping downtown or driving along the street.[12]

Both Dora and E. Royce testified that she participated in the management and control of both partnerships. This testimony, of very interested witnesses, however, did not bind the Tax Court to accept their statements as whole gospel. This is particularly true when Dora's testimony on cross-examition is scrutinized. It reveals that except for occasional discussions with her husband she was never actively engaged in the business of the partnerships. Thus, she was unable to discuss the business conferences supposedly attended by her, except in very general terms.[13] Her interest in the business was no more than that of any wife in her husband's enterprises. It is apparent that Dora did not exercise any real dominion or control over her so-called in-

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[12] Inconsistent with Dora's testimony that she performed important services are the statements in certain of the partnership returns signed and sworn to by E. Royce indicating that Dora performed no services for the partnerships. (R. 277.)

[13] To illustrate, on one occasion she testified as follows (R. 544):

> Q. Would you give the Court an illustration of some of the decisions that were made at these conferences?
>
> A. I don't know as I remember them offhand.
>
> * * * *
>
> Q. You understood my question, did you not? I asked you to give the Court an illustration of some of the conferences that were held and some of the decisions that were made at those conferences at your home?
>
> A. You just an illustration of what I—I don't know as I can remember what those were at this time.

vestments and did not "through that control influence[d] the conduct of the partnership and the disposition of its income." *Commissioner* v. *Culbertson, supra,* p. 747.

3. Enjoyment of income and capital distributions

One of the most important criteria in determining whether a wife is a genuine partner in a business is whether she "is free to, and does, enjoy the fruits of the partnership." *Commissioner* v. *Culbertson, supra,* p. 747; *Sellers* v. *Commissioner,* 218 F. 2d 380 (C.A. 9th). There is no doubt that E. Royce controlled the partnership earnings distributed to his wife. During the taxable years Dora withdrew from the two partnerships a total of $262,427.41. (R. 272-273.) Of this amount no more than $39,900 was applied in payment of so-called personal expenditures which accrued solely on her behalf and it should be noted that this figure includes $8,000 for two automobiles and $18,000 for house improvements. (R. 275.) For the remaining part, the withdrawn amounts were, except for funds used to pay state and federal income taxes, used by her husband for his own personal requirements.

Still another indication of the husband's dominion and control over these funds is found in examining the partnership checks payable to Dora. (Exs. 40, 43.) Checks in the aggregate amount of $60,307.75 were endorsed in blank by her and all other checks were endorsed in blank both by Dora *and by E. Royce.* (R. 273.) No valid reason was given at the

hearing for her endorsing the checks over to her husband.[14]

D. *Eunice (or her trust) was not a bona fide member of the partnership*

The Commissioner does not contend that a trust for the benefit of minor children set up with gift capital may never be a bona fide member of a partnership. Indeed, this Court in *Pike* v. *United States*, 231 F. 2d 688, has held such a partnership valid. However, in *Pike* the Court found that on the facts there was a valid business purpose for the formation of the partnership. Such a purpose does not exist at all in this case, and, in fact, the taxpayer nowhere in his brief on appeal attempts to set forth any such business purpose. It is clear that a fatherly desire to provide for the future of a child, while admirable, does not constitute a business purpose. *Smith* v. *Westover*, *supra*; *Sellers* v. *Commissioner*, *supra*; *Parker* v. *Westover*, *supra*.

That there was no bona fide intent to make the trust a partner becomes quite apparent when the trust instrument and the disposition of the trust's purported share of partnership earnings are considered. The Declaration of Trust discloses that E. Royce, both the settlor and named trustee, had broad

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[14] E. Royce's explanation, if it may be so designated, indicates that he accompanied his wife to the bank whenever she received a check; that he did this at her request; and that the bank tellers, presumably out of an abundance of caution, required both her and his signatures on the back of each check as a condition to cashing it. (R. 610.)

powers to control the management and investment of the trust corpus. He proceeded to exercise such powers by investing $94,100 in unsecured "loans" to himself and $281.25 in governmental or other conventional securities. (R. 285.) Under the instrument he had sole discretion as to whether or not any part of the partnership earnings should be paid over to his daughter or accumulated for her use and benefit. In practice during the five years in question he paid out $2,200 to his daughter, which amount was largely used to pay her living and other personal expenses while attending college. (R. 284.)

The trust instrument did not require any payment over to Eunice. At the time of her thirty-fifth birthday, "if, in the judgment of the trustee" she "desires to receive the corpus * * * and she is considered * * * capable of managing the trust estate wisely," such a payment might be made. (R. 281-282.) It is apparent that E. Royce had untrammeled control over the "trust" income and that he used it for his own benefit. The largest withdrawals from the trust account except for the payment of income taxes were for his personal uses. The "loans" to E. Royce aggregated $94,100 on December 31, 1949. Of this amount $7,100 was loaned to Royce, Inc., and the balance of $87,000 to E. Royce personally. E. Royce was the principal stockholder of Royce, Inc. The loan to Royce, Inc., was repaid in 1950, those to Royce personally have not been repaid. (R. 285-286.)

While the form of the Declaration of Trust and the partnership agreement were perfectly satisfac-

tory, in substance they effected no change whatsoever in the business of the partnership or in the disposition of the profits realized therefrom. Such a sham patently fails to meet the requirement of *Culbertson* (p. 747) that the so-called partner "enjoy the fruits of the partnership." The contention that the trust was a valid partner in the Seattle partnership for tax purposes is clearly without merit; the partnership arrangement in respect of the trust was merely a paper re-allocation of income. Cf. *Smith* v. *Westover, supra; Parker* v. *Westover, supra; Harvey* v. *Commissioner*, 227 F. 8d 526 (C.A. 6th); *Economos* v. *Commissioner*, 167 F. 2d 165 (C.A. 4th), certiorari denied, 335 U.S. 826; *Zander* v. *Commissioner*, 173 F. 2d 624 (C.A. 5th); *Stanback* v. *Robertson*, 183 F. 2d 889 (C.A. 4th); *Feldman* v. *Commissioner*, 186 F. 2d 87 (C.A. 4th).

E. *All of the partnership interests in question are properly taxable to E. Royce*

From the foregoing it is submitted that the Tax Court was correct in finding that Dora and E. Royce "at no time really and truly intended Dora to be a bona fide partner in carrying on the business of the Portland and Seattle partnerships." (R. 278.) Equally correct was the holding "that Eunice Royce was not a bona fide partner in the partnership." (R. 286.) These findings of fact are not "clearly erroneous" (*Smith* v. *Westover, supra*), since it is apparent that "no real change in the economic or financial status of the * * * family was affected by the partnership" (*Parker* v. *Westover, supra*, p. 492).

CONCLUSION

The decisions of the Tax Court from which the taxpayers here petition for review are all correct and should be affirmed.

Respectfuly submitted,

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APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) [As amended by Sec. 1, Public Salary Tax Act of 1939, c. 59, 53 Stat. 574] *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

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(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) [As amended by Sec. 166(a), Revenue Act of 1942, c. 619, 56 Stat. 798] *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 201 (c) (5), section 204 (c) (11) and section 207 (a) (2) and (b) (3) (where the reference is to dividends of insurance companies paid to policy holders)) means any distribution made by a corporation to its shareholders, whether in money or in other

property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * *

(c) *Distributions in Liquidation.*—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, * * *

* * * *

(g) *Redemption of Stock.*—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

* * * *

(i) *Definition of Partial Liquidation.* — As used in this section the term "amounts distributed in partial liquidation" means a distribu-

tion by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

* * * *

(26 U.S.C. 1952 ed., Sec. 115.)

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity.

(26 U.S.C. 1952 ed., Sec. 181.)

28 U.S.C.:

SEC 1732 [as amended by Secs. 1 and 3, Act of August 28, 1951, c. 351, 65 Stat. 205]. *Record made in regular course of business; photographic copies.*

(a) In any court of the United States and in any court established by Act of Congress, any writing or record, whether in the form of an entry in a book or otherwise, made as a memorandum or record of any act, transaction, occurrence, or event, shall be admissible as evidence of such act, transaction, occurrence, or event, if made in regular course of any business, and if it was the regular course of such business to make such memorandum or record at the time of such act, transaction, occurrence, or event or within a reasonable time thereafter.

All other circumstances of the making of such writing or record, including lack of personal knowledge by the entrant or maker, may be shown to affect its weight, but such circumstances shall not affect its admissibility.

* * * *

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.115-9. DISTRIBUTION IN REDEMPTION OR CANCELLATION OF STOCK TAXABLE AS A DIVIDEND.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

The question whether a distribution in connection with a cancellation or redemption of stock is essentially equivalent to the distribution of a taxable dividend depends upon the circumstances of each case. A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913. On the other hand, a cancellation or redemption by a corporation of all of the stock of a particular shareholder, so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend. * * *

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